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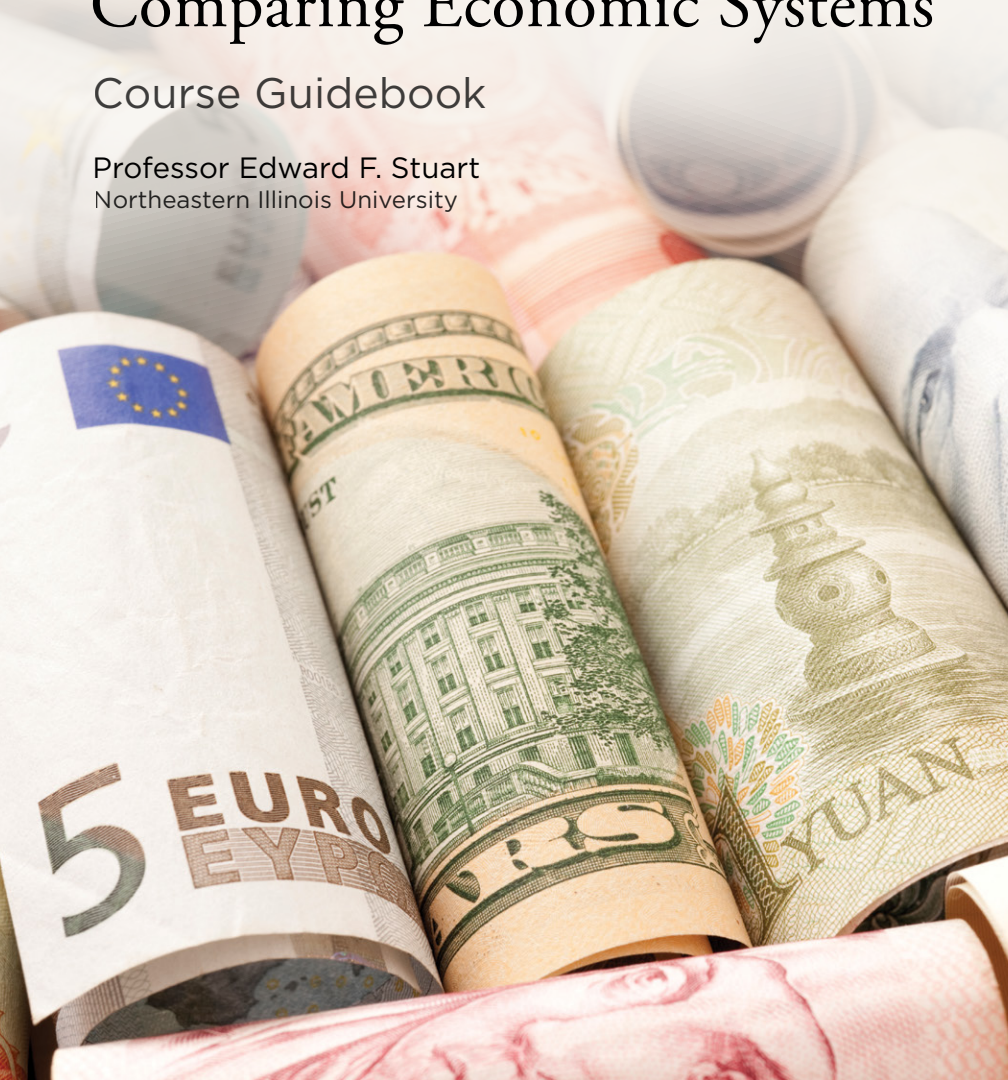
Subtopic  
Economics

# Capitalism vs. Socialism

## Comparing Economic Systems

Course Guidebook

Professor Edward F. Stuart  
Northeastern Illinois University



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**E**dward F. Stuart is a Professor Emeritus of Economics at Northeastern Illinois University, where he has been a member of the faculty since 1986. He earned his Ph.D. in Economics at the University of Oklahoma, specializing in International Economics and Russian and Eastern European Studies.

Professor Stuart teaches courses in international economics, the economics of the European Union, comparative economic systems, European economic history, and macroeconomic theory. He is also the chair of the Faculty Advisory Committee on International Programs and has led study tours to France, Germany, Austria, Italy, and Spain.

Professor Stuart has been a visiting guest professor at the University of Salzburg in Austria, the Burgundy School of Business in France, the Ural State Pedagogical University in Russia, and the Warsaw School of Economics and the University of Warsaw in Poland. In January 2014, he served as a guest professor at the China University of Petroleum-Beijing's Academy of Chinese Energy Strategy, where he lectured in macroeconomic theory and forecasting. Professor

Stuart has also served as an adjunct faculty at Loyola University Chicago's Quinlan School of Business, where he has taught classes in microeconomics, macroeconomics, and international business economics for students in the MBA program.

For the past 15 years, Professor Stuart has worked as a consultant to several international relocation firms and has made presentations on the histories, economic and political systems, geographies, and current events in a wide range of countries. These presentations have the objective of preparing the participants to be effective and successful professionals in the foreign countries to which they have been transferred.

Professor Stuart has published widely in the field of economics. His most recent publication is "Building Regional Competitive Advantage: Lessons from U.S. Experiences for Poland and Other New EU Member States." Professor Stuart is completing a textbook introducing the economics of the European Union to American college students and interested scholars. The book is being coauthored by his colleague at the Burgundy School of Business, Professor Jean-Guillaume Ditter.

Professor Stuart has been an economic analyst on radio and television programs, including NPR, Chicago's *WGN Morning News*, FOX 32 Chicago's evening news, WTTW's *Chicago Tonight*, and News Talk 980 CKNW in Vancouver, Canada. He has also given interviews to print and online media, including MSNBC.com, the Associated Press, *Bloomberg Businessweek*, and the French business daily *Les Echos*. ♦

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# Capitalism vs. Socialism

## Comparing Economic Systems

**T**his course covers the important economic systems in the world today. It also addresses the historical background and big ideas that created the different economic systems.

The course explains the key insights of Adam Smith, the first great economist and intellectual godfather of free market capitalism. Then, the course analyzes the ideas of Karl Marx, the chief critic of the capitalist system and the first major proponent of a socialist system. In the modern era, the contrasting ideas of John Maynard Keynes and Milton Friedman help explain the conflict between the arguments for and against active government intervention in a market economy.

The actual development of British and American capitalism highlights the advances and problems created by industrial capitalism. The reaction to the excesses of early industrial capitalism created the first socialist movements that attempted to reform and improve the capitalist system. Early “utopian” socialists, who often had a religious and moral zeal to improve the lives of ordinary workers, created the first socialist political parties, trade unions, and worker cooperatives. Some of the most interesting reform attempts were the New Lanark mills in Scotland, the Amana Colonies in Iowa, and the Mondragon cooperative society in the Basque region of Spain.

The first country to create a brand-new economic system was the Soviet Union. The course examines the history of the Russian Empire and the forces and events that led to the Bolshevik Revolution and the creation of the Union of Soviet Socialist Republics. How did the Bolsheviks under Vladimir Lenin and Leon Trotsky organize an economy with little or no private property? The answer is this: with little or no market institutions and no price and profit information. After Lenin died and Joseph Stalin established himself as the supreme and unquestioned leader of the Soviet Union, the Soviet economy created the first command planning system. The course analyzes the key institutions in this system and the incentives and behaviors of the economic planners, enterprise managers, and ordinary Soviet workers and farmers.

After World War II, the Soviet economic and political system was imposed on the countries of eastern Europe by the victorious Red Army. How were the economies of Poland, Hungary, Czechoslovakia, and East Germany transformed from market economies to government-owned and planned economies? The contrasting economies of East and West Germany provide an almost laboratory experiment in comparative economic systems. These two countries have the same history, the same language and culture, and the same people. The only difference between them is their economic systems. What were the key institutions of the West German economy and its social market economic system? How did the centrally planned economy of East Germany function? What eventually led to the collapse of the socialist economies of eastern Europe? And what forces unleashed by the reforming efforts of Mikhail Gorbachev led to the collapse of the Soviet Union?

The course examines some economies that attempt to capture the best aspects of capitalism with some reforms and government regulation advocated by the early utopian socialists and social democrats. In contrast to the private enterprise economy of the United States, the economies of Great Britain, France, and Sweden

have a significant governmental involvement in the areas of health care, education, housing, transportation, and public utilities. These countries also do a considerable amount of income redistribution through progressive income taxes and a comprehensive social welfare system.

The course examines the economy of the People's Republic of China and its fascinating attempt to combine Communist Party control with private enterprise in agriculture and manufacturing. The course then analyzes the so-called Asian Tiger economies of South Korea, Taiwan, and Singapore. They all have used a strong central government to develop a modern, capitalist economy that competes successfully in world markets. Finally, the course examines the economy of Slovenia and its attempt to transform itself from a communist-type, planned economy into a mixed economy with significant private enterprise but retaining much of the social welfare policies that create an egalitarian society.

The course ends with the question of whether the world's economic systems are converging—becoming more similar—or whether there are still significant differences in national cultures and values that cause different societies to choose different economic systems. ♦



## *Lecture 1*

# Gorbachev's Hello and the Soviet Goodbye


**T**HERE ARE DIFFERENT WAYS OF LOOKING AT THE world, and differences in values manifest themselves in different social policies. Comparative economics is a fascinating subject that attempts to analyze, and answer, many important social questions. Comparative economics is the study of different systems of economic organization—notably capitalism, socialism, communism, and mixed economies. ♦

## Debates about Comparative Economics

- ◀ Virtually all countries and societies around the world debate the role of governments and market institutions. Some of the questions that debates about comparative economics raise and seek to answer are as follows:
  - ◇ What are the goals of a good society?
  - ◇ How should societies be organized?
  - ◇ What is the best way to make sure that people have a decent standard of living?
  - ◇ Are people best motivated by self-interest and individual success, or do we have a basic moral sense of solidarity? Are we motivated by altruism and regard for others?

## Health Care

- ◀ In the United States, the perennial health-care debate is, in an important sense, a debate about comparative economic systems. Should health care be provided by the government? Should health care be a purely individual responsibility and left to a free market, consumer-driven system?
- ◀ There are many different forms of health care in between the extremes of a completely government, or public, system and a completely free enterprise system of individual choice and payment. Governments could subsidize health care but let individuals decide what kind of health care they should purchase. Governments could mandate that individuals must have private health insurance.



Different countries have vastly different health-care systems.

- ◀ In the United Kingdom, the government—through the National Health Service—is the sole provider of health care, and all of its citizens are treated in public hospitals and clinics, paying no out-of-pocket costs. Taxes on all residents are the source of revenue to pay for this government-provided health care.
- ◀ In France, all residents get a health-care card for services that may be purchased from a variety of sources at the patient's discretion. Again, the funding comes from a fairly significant level of taxation. Japan has a similar system to France's.
- ◀ In the former Soviet Union, all citizens typically were assigned to a particular clinic and hospital, where they would receive their medical care. Often, the clinic and hospital were attached to the enterprise where the Soviet citizen worked, and his or her family had little or no choice as to who would be their doctor or surgeon.

## Education

- ◀ Another important social question—which again can be viewed through the lens of comparative systems—is that of education.
- ◀ Should education be funded by the government and be free to all residents? Should individual families have choices about where their children go to school?
- ◀ Is a mixed system of public and private education better, because it offers more choices? Or does a system of mixed public and private education inevitably lead to a situation where the poor and working-class families send their children to underfunded public schools and upper-income, rich families send their children to private schools that have more resources and better-paid, more-talented teachers? If so, would this undermine a commitment to democracy and equal opportunity?
- ◀ Maybe there can be private schools and individual choice, but the government could provide subsidies and vouchers to poorer families to help them choose better schools for their children.

## Mass Transportation

- ◀ In many crowded cities, maybe not everyone should be driving their own cars to work, or school, or shopping. Should mass transportation be an alternative to private automobiles?

- ◀ You can certainly make the case that a car is a source of freedom and individual choice. But if everybody is driving, what about the congestion this causes? What about the pollution? What about traffic accidents and the lives of pedestrians? Are you free only to be stuck in someone else's traffic?
- ◀ If a society is to provide mass transportation as an alternative to private automobiles, who should pay for the trains, buses, subways, trams, and ferries we'd need? Should riders pay the whole cost of the bus trip?
- ◀ If more people ride the bus and you keep driving your car, aren't you—as an automobile driver—much better off because all the people on the bus are not driving? If so, then your freeway trip is much less congested and you can get to work in much less time. But, then again, shouldn't you pay for some portion of that bus travel, because you are getting some of the benefits?
- ◀ The nature of transportation is taking on ever-greater social and global importance. Does your driving a gas-powered car contribute to the problems of climate change? If so, should governments tax gasoline more heavily?
- ◀ The United States has relatively cheap gasoline in comparison to the social welfare states of the European economy, where gasoline is much more expensive. And the reason for this has to do with choices. The high price of gasoline in Europe relative to that in the United States reflects radically higher taxes—and political decisions about how transportation of all forms should be financed and produced.
- ◀ Another important question—in addition to the questions of how mass transportation is to be paid for—is how mass transportation should be produced.

The late British Prime Minister Margaret Thatcher thought that mass transportation was a type of socialism. And—as a self-described supporter of free enterprise and individual rights—she believed that citizens should be free to drive cars whenever and wherever they liked.



- ◀ Should mass transportation be provided by private enterprises that make a profit? If they can't make a profit, should they be subsidized by the government? Or should mass transportation be produced by public enterprises that are owned by a government and financed, at least partially, by all taxpayers?
- ◀ Should there be a difference between local mass transportation (such as city buses) and intercity transportation (such as airlines and long-distance trains)?

- Many different transportation systems exist throughout the world. In France, for example, the intercity trains—including the famous TGVs—are a government-owned enterprise.
- Japan has partially privatized some of its intercity trains, and some of Japan's famous bullet trains are the property of private railroad companies.
- Some governments own a national airline, such as Singapore Airlines, which is owned by the government of Singapore. The United States has purely private commercial airlines, although sometimes they have been bailed out by the U.S. government.
- Here's a similar question: Should large industrial enterprises sometimes be owned by governments—or be partially owned by governments—to promote the public good?
- The German automobile company Volkswagen is partially owned by the state government of Lower Saxony, where Volkswagen has its headquarters and main factory. The government of Lower Saxony also places some representatives on Volkswagen's board of directors. And, at least in theory, these representatives represent the citizens of the surrounding region, who are affected by anything such a large enterprise does. Large private enterprises in Germany must also include workers' representatives on their boards of directors.
- This German system is called *Mitbestimmung*, or codetermination. It's a variation of private property and its control. And it's different than in the United States, where only private shareholders typically get a place on a company's board of directors.

## Housing

- ◀ One more example of comparative systems in economics is seen in the provision of housing.
- ◀ Most housing in the United States is owner-occupied, or rental housing owned by a private landlord. There are some examples of public housing, usually in urban areas. But many countries have much more extensive government-owned, or cooperatively owned, housing than commonly is found in the United States.
- ◀ If you consider basic housing a human right, then it might make sense for public bodies to build and own housing units and let poor or disadvantaged residents live in them for free or minimal costs. Or you might make the argument that private construction and private ownership is the most efficient way to produce housing.
- ◀ In this case, if you want to provide the poor and underprivileged with housing they could not afford on their own income, then government subsidies might be a better way of providing everyone with an adequate level of basic housing.
- ◀ So, even in a private market economy, such as that of the United States, many issues and problems have, at their base, a comparative-systems argument. Is the public sector and government the best provider of some products and services, or should human needs be left mostly to the private sector, albeit with some modest amount of government regulation or subsidy?

## Readings

REID, *The Healing of America*.

STIGLITZ, *Whither Socialism?*

## Questions

- 1 How would your different political, moral, and religious values cause you to prefer a particular kind of economic system?
- 2 Do you think that most people are motivated by self-interest or by concerns for their fellow human beings? What does this have to do with capitalism versus socialism?



## Lecture 2

# Adam Smith, Karl Marx, Keynes, and Friedman

**E**VERY ECONOMIC SYSTEM IS BASED ON THE IDEAS of one or more big thinkers. While there are many important economic thinkers, four men—Adam Smith, Karl Marx, John Maynard Keynes, and Milton Friedman—represent virtually all of the major ideas in practice about how an economy should be organized and how it should work. This includes ideas about private property versus state ownership, government regulation versus free market decisions, and high taxes versus low taxes on consumption spending. ♦

## Adam Smith

“Humans have a natural propensity to truck, barter, and exchange.”

— SMITH



- Adam Smith was the first great economist and systematic thinker about economic questions. His most famous book, *An Inquiry into the Nature and Causes of the Wealth of Nations*, was published in 1776. In this book, Smith outlined many groundbreaking ideas that changed the landscape of economic thinking forever, but three of these ideas serve as the foundation for his view of economics: the nature of wealth, the necessity of free markets, and the benefits of specialization.
- During Smith's time, most people thought that national wealth meant lots of gold in the king's treasury, or a big army, or impressive government buildings. But he disagreed. He said that the most important kind of wealth was a nation's production of goods and services that made the lives of ordinary people better.

- ◀ In the same way, in assessing or examining the health of a nation's economy today, typically we focus on gross domestic product—that is, the total production of goods and services in an economy.
- ◀ Smith's thinking about how to increase the wealth of nations rests on his ideas about human nature and human motivation. He believed that most people were concerned about other people and could be motivated by sympathy for their fellow human. But he thought that a stronger human motivation was self-love and concern for immediate family and close friends.
- ◀ Taking into account humans' self-interest—along with the human desire to interact—Smith recognized that people, by their very nature, love to trade and shop. He thought that bargaining and exchange activities were unique to human beings.
- ◀ What emerges from this view is Smith's belief that a commercial society—based on market institutions—is the best economic system humans could create and sustain. He didn't use the label "capitalism" for this ideal system, because that word didn't exist yet; it would be invented by another great thinker, Karl Marx, in the 1840s.
- ◀ Smith put all of his ideas together in the thesis that a rational human economy would be based on exchange, motivated by self-interest. He believed that by appealing to the self-interest of individual producers and businesses, they would produce what society wanted, and the general good of the society would be promoted.
- ◀ This is also where Smith's most famous idea, known as the invisible hand, comes in: In an economy based on self-motivated exchange, the economy is guided by an invisible hand—a hand that benefits all parties participating in the exchange.



The word “economics” comes from the Greek word for management of household expenses, and it first appears in the writings of Aristotle in the 4<sup>th</sup> century B.C.

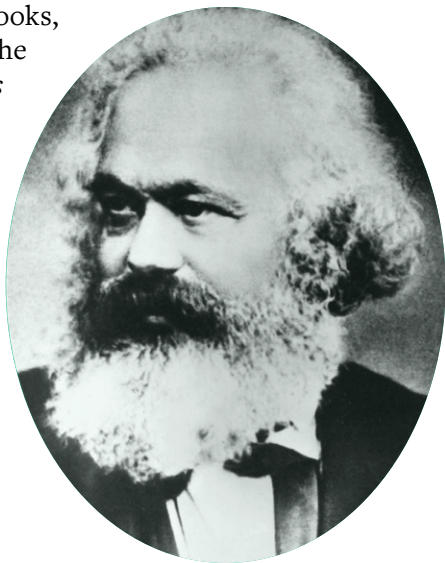
The word “economist” was invented late in the 18<sup>th</sup> century by a group of professors at the University of Paris known as the physiocrats, who believed that all wealth derived from land. They adapted the Greek term *okionomia* to label their own nascent profession *economiste*.

- ◀ Smith was a great believer in freedom. At the time he was writing, an individual’s job and social position were mainly determined by what kind of family you came from. But he thought that people should be free to choose their own occupations and professions.
- ◀ Smith believed that there should a lot of freedom when it comes to who could sell in a market. No one person, or small group, should have a monopoly in the sale of a good or service.

- ◀ Although Smith was very much in favor of markets, he was also very suspicious of businessmen. He assumed that when people in the same business got together, they were usually cooking up some scheme to rig the market and cheat the consumer. So, he was a firm believer in the necessity of the state to keep a close eye on the markets and watch out for anticompetitive behavior.
- ◀ Smith also recognized that the successes of some would lead to inequality in incomes. In other words, some people would get rich and some people would be poor. The reasons could be differences in skill, luck, effort, and the training needed to succeed in some occupations. Therefore, it would be necessary for the state to provide some basic standard of living.
- ◀ Smith saw inequality in incomes as a necessary evil of a market society. The best way to prevent too much inequality was to promote as much competition as possible and make the market as big and wide as could be. Competition from other regions and other countries would limit the power of local businessmen to control the market for their benefit.
- ◀ Smith was a big believer in free trade, which is the basis for specialization. He saw specialization as a second main source of increased wealth, in addition to self-interested, market-based exchanges. If people could specialize and trade, each person could focus on what they were good at—and trade for everything else they'd need.
- ◀ Specialization was also a source of innovation and progress. If people specialize, they learn—or figure out—ways to do the job better and faster.

## Karl Marx

- ◀ Karl Marx authored many books, pamphlets, and articles—the most famous of which was *Das Kapital*. Like Adam Smith, Marx set forth several key ideas that would change the face of economics, four of which are class society; the development of capitalist industry; the rise of the working class, or proletariat; and the inevitability of socialism.



*“The philosophers have  
only interpreted the world, in various ways.  
The point, however, is to change it.”*

— MARX

- ◀ Unlike Smith—who saw markets as a way to bring people together—Marx insisted that different groups in society have conflicting interests. Marx assumed that as market societies develop, some men would become rich and own more and more of the productive machinery and factories. Everyone else would have to sell their own labor to earn enough to live.

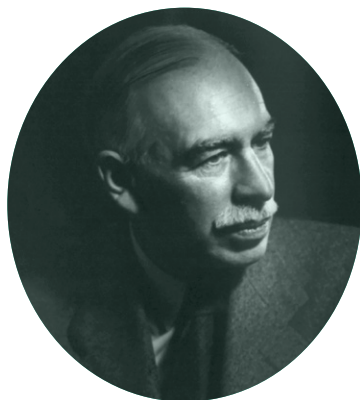
- ◀ The rich capitalists would come from landlords, successful merchants, and traders. The working class consisted of former peasants, poorer landowners, and unsuccessful artisans who were bankrupted by industrial capitalists who mass-produced cheaper products.
- ◀ Marx lamented the decline of artisan work and handicraft production, which gave the maker some direct control over the product and satisfaction at seeing the finished good produced. But he stipulated that industrialization offered benefits to society and set the stage for a higher standard of living. Here, we find a surprising area where Marx and Smith agreed.
- ◀ In Marx's view, the great cities of capitalist countries would be the places of giant factories and large populations. These factories would turn out countless numbers of products cheaply and efficiently. And that would, indeed, improve the lives of those entering from rural societies.
- ◀ The major problem Marx found with this form of development was that most profits from this production went to the owners of the factories, and not to the workers.
- ◀ Marx also argued that as growing numbers of workers came to work in the factories, their bargaining power would diminish. He envisioned more and more workers competing against each other for the same or fewer jobs, having the effect of driving down wages.
- ◀ The capitalists would become more and more monopolistic. And, therefore, fewer and fewer would dominate the market, as well as politics and society.

- ◀ The declining power of workers and the growing power of the capitalists would force wages to subsistence levels—just enough income to keep the workers and their families alive.
- ◀ Marx believed that the workers' only hope was to band together in trade unions and in support of political parties formed around these trade unions. The labor parties, social democratic parties, and socialist parties of Europe all derive some of their ideas from Marx.
- ◀ Marx envisioned that the labor parties and workers' organizations would be powerful enough to overthrow capitalism and establish social control of industry. This control would be used to benefit workers and to divide the total revenues and profits of industry among the entire population. This would be the way in which inequality would be eliminated and democratic control of industry would be established.
- ◀ Marx thought that a successful workers' revolution would begin in an advanced economy, such as that of Great Britain or Germany. A society ripe for revolution would be highly developed, where workers were skilled at industrial labor and manufacturing processes. But the first workers' revolution actually occurred in poor and underdeveloped Russia. And it didn't turn out so well.
- ◀ Social equality—and the idea of everybody being paid the same—sounds humane and democratic. But they can have some unintended consequences.

## John Maynard Keynes and Milton Friedman

*“Capitalism is the astounding belief that the most wickedest of men will do the most wickedest of things for the greatest good of everyone.”*

—KEYNES



- Two 20<sup>th</sup>-century thinkers loom large over most modern economies: John Maynard Keynes and Milton Friedman.
- Modern macroeconomics—which is the scientific analysis of the overall economic performance of national economies—owes its existence to Keynes and his followers. Most governments around the world today practice some macroeconomic policies to stabilize their economies and to promote growth. We see the influence of Keynes as governments manipulate taxes and government spending levels to influence overall economic performance.
- Milton Friedman was a free market advocate who created an entire school of modern economics at the University of Chicago. He believed that Keynes was wrong and that activist governments created more problems in the economy than they solved.

- ◀ Friedman derived his ideas from Adam Smith's belief that free markets—if left to themselves—would produce beneficial results for all of society and that too much government interference, in contrast, would damage the workings of demand and supply and the profit motive. Such damage created economic inefficiency and reduced economic growth.
- ◀ Most conservative political parties and thinkers owe a great deal to Friedman's ideas and arguments. Margaret Thatcher in the United Kingdom and Ronald Reagan in the United States are just two of the most prominent political leaders to put his ideas into practice.

*“There’s no such  
thing as a free  
lunch.”*

— FRIEDMAN



## Readings

BUCHAN, *Capital of the Mind*.

FRIEDMAN AND FRIEDMAN, *Free to Choose*.

MARX AND ENGELS, *Selected Works in One Volume*.

SKIDELSKY, *Keynes*.

## Questions

- 1 What did Adam Smith think about the basic nature of human beings? How did this influence his advocacy of a market system?
- 2 Where did Karl Marx get his initial ideas about class conflict? How did Marx think class conflict could be eliminated?



## Lecture 3

# How to Argue GDP, Inflation, and Other Data

**T**HIS LECTURE WILL EXPLORE DIFFERENT WAYS IN which economies can be compared and evaluated. Many of these differences reflect national values, ideologies, and opinions. This lecture will examine some of the most commonly used measures of comparative economic performance and learn how they help us judge which economies are doing better than others. ♦

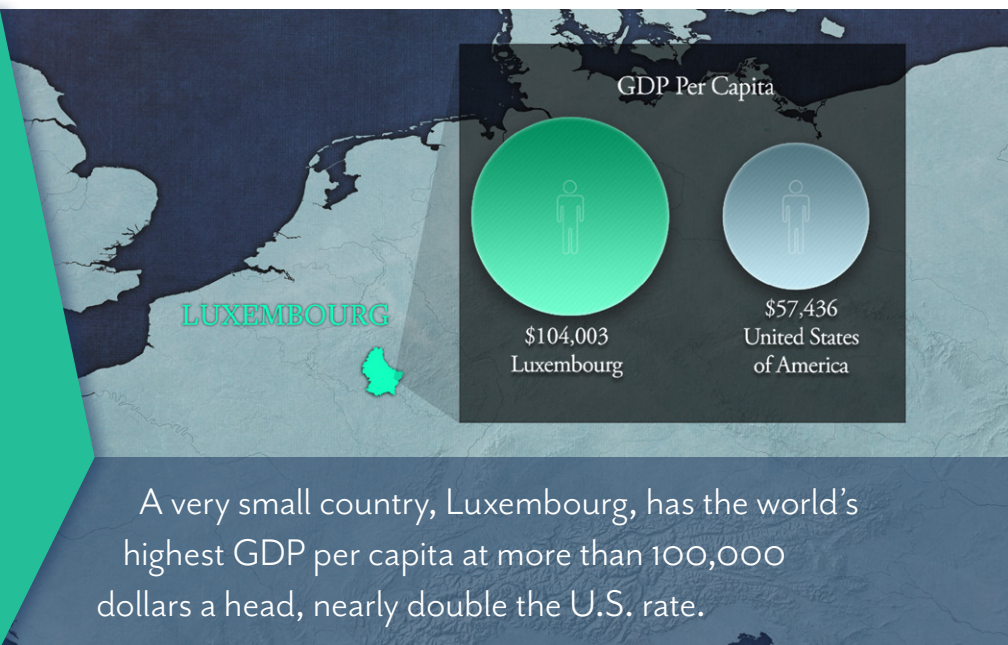
### Gross Domestic Product



- ◀ The most commonly used measure of economic performance is gross domestic product (GDP). This statistical concept attempts to capture the value of all goods and services that an economy produces in a given time period, usually one calendar year.

- Most countries calculate and publish their economy's annual GDP. And this number is becoming more and more standard. The Organization for Economic Cooperation and Development (OECD) in Paris is one of the main international organizations to advise countries on how to calculate their GDP so that it is comparable with other countries' GDPs. The OECD provides advice, studies, and statistical consulting to high-income countries around the globe, including to the United States, Canada, and Japan.
- The GDP statistic was invented by a Russian American immigrant economist in the United States named Simon Kuznets, who was tasked by the administration of President Franklin D. Roosevelt to come up with a measure of the economic potential of the entire U.S. economy. Kuznets was awarded the Nobel Prize in Economics for his development of the GDP statistic.
- GDP is an aggregate number. It is a summing up of all the sectors of an economy and all the products and services that an economy produces.
- In the United States, the calculation of GDP is performed by the Bureau of Economic Analysis, which is part of the Department of Commerce.
- Exports are part of U.S. GDP because they are goods and services produced in the United States and sold to foreigners. Imports are subtracted from U.S. GDP because they are part of some other country's production. However, most of what we buy in the United States is produced in the United States. The biggest household expenditure category is housing, and most housing is produced in the United States.

- ◀ Business investment spending on buildings, equipment, and capital goods is also included in GDP. Finally, governments buy goods and services, too. Military goods, police protection, fire protection, education services, government buildings, and medical care are all mostly produced in the United States.
- ◀ The United States has the world's largest GDP. But that doesn't mean that it has the richest citizens. The United States distributes its GDP among approximately 320 million residents. You can't judge living standards by GDP alone; you must adjust for population. GDP per capita, or GDP per person, is calculated by dividing a country's GDP by its population.



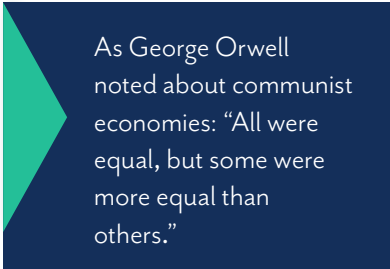
- Many countries with a growing GDP might have falling living standards because their populations are growing faster than their GDP. China introduced the one-child policy decades ago for this reason. Since then, Chinese GDP per capita has risen very quickly. Ironically, the Chinese abandoned the one-child policy because it was too successful. Today, China's population is aging, threatening to slow the growth of the Chinese economy.
- Another important adjustment that frequently needs to be made to the GDP statistic is to account for the problem of inflation. GDP is calculated by adding up all the monetary values of current production.
- The people who calculate GDP actually produce two versions: current-dollar GDP, which measures GDP using current prices; and constant-dollar GDP, which uses some base year—or constant price standard—to calculate what is also called real GDP. When economists use the adjective “real” before some monetary statistic, this means that the statistic has been adjusted for inflation.
- Real per capita GDP is the main comparative statistic with which to compare societies. It's the best measure available to us for comparing most countries in the world.

## Income Distribution

- Another important question is how income is distributed. Are most residents of a country similar in incomes, or is there a big gap between the rich and the poor? Just dividing GDP by population doesn't tell you anything about how evenly, or unevenly, total income is distributed. Averages—what real GDP per capita is—can be quite misleading.

- ◀ To illustrate this, consider what happens when Bill Gates walks into a room. Let's say that the room holds 20 people and that the occupants have an average income of \$50,000. Then, Bill Gates, one of the world's wealthiest men, walks into the room. Now, the average income in the room shoots up into the billions of dollars. Of course, that doesn't give an accurate picture of the living standards of those 21 people.
- ◀ A more descriptive statistic might be median income, based on the income of the person in the exact middle of the group. If the original 20 people all had very similar incomes, the median income might not change, even after Bill walked in.
- ◀ Other common measures also give us a picture of the distribution of income in a country, including income inequality. These measures include calculating the share of total income received by the top 1 percent or top 10 percent of the population.
- ◀ Other, more complicated measures are the ratio of incomes of the top 10 percent to the bottom 10 percent and the ratio of the top 20 percent to the bottom 20 percent. These are called decile and quintile ratios, respectively, and they get larger as income gets more unevenly distributed.
- ◀ This topic has become more important as income in the United States flattened out relative to some other high-income countries.
- ◀ A last and most complicated measure of income inequality is called the Gini coefficient, named after Italian economist and statistician Corrado Gini. The Gini coefficient can vary between 0 and 1. The closer the Gini coefficient is to 1, the more uneven income distribution is in a country.

- Many societies place a high value on social solidarity and seek to minimize the extremes of rich and poor. These countries usually have high progressive tax systems—that is, the higher the income, the bigger the tax rate—and significant social welfare programs.
- Progressive taxes are usually personal income taxes rather than sales or excise taxes, which typically are a fixed percentage of the price of some good or service.
- There's no objectively correct level of income distribution or inequality. Some societies value individual freedom and self-sufficiency, while others place a higher value on social equality and avoiding extreme income differences. These conflicting values are one of the most important and interesting differences among competing economic systems.
- One goal of socialism was to eliminate, or at least drastically reduce, income and class inequality. Socialists criticized capitalism for creating these differences. In some ways, socialist or communist countries did reduce inequality, though not completely.
- In capitalist economies, big debates are under way today about how much inequality is supportive of economic growth and whether it is possible to have too much inequality.
- Most economists argue that some inequality is necessary to encourage innovation and business performance.



As George Orwell noted about communist economies: “All were equal, but some were more equal than others.”

- ◀ But some minimum level of income needs to be available for everyone in an economy so that all citizens can lead healthy and productive lives. There should be adequate levels of food, shelter, health care, and education for an economy to produce at its maximum potential. A society of malnourished and uneducated people won't be able to provide efficient workers for capitalist entrepreneurs, nor consumers for retail businesspeople.
- ◀ One key reason for the rapid economic growth of the American economy in the 19<sup>th</sup> century was the country's development of a public education system—first at the primary- and secondary-school levels and later at the college level. Land-grant public universities, which charged little or no tuition, gave many Americans a higher education that was available in Europe only to the very upper classes and nobility.

## Quality of Life and Health

- ◀ A new field of comparative economic achievement has focused directly on the quality of life and health of a country's population. These new measures and statistics have a variety of names, such as the Human Development Index.
- ◀ Life expectancy and infant mortality rates are correlated with real GDP per capita. Higher-income countries almost always have better food, medical care, and education and more access to important information.
- ◀ A new field of comparative economic performance that focuses on human health and development is called anthropometry, developed by American economists John Komlos and Richard Steckel. Their unique contribution was to focus on differences in average height among different populations.

- It turns out that height is a pretty good measure of all kinds of social conditions, such as nutrition, health care, prenatal and neonatal conditions, economic status, income distribution, and education. Today, many studies compare the height of different countries' populations.
- This is also a simple and direct way of comparing standards of living. Countries that have high standards of living will have taller populations. In countries with improving economies, populations will be growing taller.
- Height differences tell a much larger story about health, education, and economic opportunity. Countries with improving economies will observe significant gains in average height over time.
- For all of these reasons, it's disconcerting that average height in the United States has not been increasing in the last few decades. Economists and public health specialists have some possible explanations, including worsening nutrition and diet, uneven access to health care, and increasing economic inequality and opportunity.

As of 2017, the tallest populations are in the Netherlands and Latvia. Dutch men are the tallest in the world, and Latvians are the tallest women. The shortest men are in East Timor, and the shortest women are in Guatemala.



## Employment and Unemployment

- ◀ Two more pieces of data are commonly used to measure the ability of an economy to provide jobs for its residents and a dependable money supply.
- ◀ Employment and unemployment statistics provide a measure of how well people who want to work can find jobs. Low unemployment rates mean jobs for new graduates, new opportunities for workers looking to change careers or location, and optimism for individuals and families about their futures. High unemployment rates contribute to anxiety and a stagnant economy.
- ◀ Employment and unemployment statistics are collected somewhat differently in each country but are becoming more comparable thanks to the OECD and the International Labour Organization (ILO), which is an office of the United Nations devoted to promoting policies to better the lives and working conditions of labor around the world. The ILO also advises countries on proper ways to collect and publish employment and unemployment data so that comparative analysis is possible—and realistic.

## Inflation

- ◀ Another measure of comparative economic performance is inflation, which is defined as a general rise in the cost of living. It doesn't refer to the price of one product or another getting more expensive, but rather an economy-wide rise in prices. Inflation hurts almost everyone, especially the poor and the old.

- ◀ In the United States, inflation is measured by the Bureau of Labor Statistics, which is part of the Department of Labor.
- ◀ Hyperinflation is usually defined by economists as inflation of more than 50 percent a year. Under hyperinflation, nobody wants to exchange goods and services for money, and barter becomes much more common. But barter is very inefficient and time consuming. And very often, hyperinflation is a precursor of political and social upheaval.

### Readings

BUREAU OF ECONOMIC ANALYSIS, “Survey of Current Business.”

BUREAU OF LABOR STATISTICS, “Beyond the Numbers.”

ORGANIZATION FOR ECONOMIC COOPERATION AND

DEVELOPMENT, *OECD Factbook 2015–2016*.

### Questions

- 1 What do you think are the most important measurements of how well an economy is doing?
- 2 Why won't people ever agree on what is the most important measure of economic success and performance?



## *Lecture 4*

# British Revolution: Industry and Labor

**G**REAT BRITAIN LAUNCHED MODERN INDUSTRIAL capitalism in the late 18<sup>th</sup> century by combining a series of essential but previously uncoordinated economic and political institutions. In the political sphere, these institutional innovations included the basic liberties outlined in the Magna Carta and safeguarded by parliamentary democracy. In the economic sphere—on which this lecture will concentrate—they included trade finance, shipping insurance, and a corporate form of ownership facilitated by stock markets and public investors. Together, these developments helped propel Britain to become the first country in the world to create large factories and export its products to foreign markets. ♦

## Financial Innovations

- ◀ Financing foreign trade depends on the existence of insurance contracts, which were developed during the Middle Ages by the first Venetian merchants, who shipped their goods all over the Adriatic Sea and eastern Mediterranean.
- ◀ At first, this insurance was created by several wealthy merchants, who would pool their funds to insure each individual voyage. When a ship was lost to storms or pirates or foreign navies, each individual investor would lose a small share of the cost of the insurance. But successful voyages typically more than covered the costs of such losses, thereby generating profits to finance other voyages—and to pay for the insurance.
- ◀ The ad hoc collections of merchants called on to insure individual voyages was gradually replaced by companies set up to be permanent insurers of shipping and other types of commerce. And individual businessmen skilled at determining the risks of various business enterprises became insurance brokers.
- ◀ Another financial innovation was the rise of corporate ownership and investment. The Dutch perfected the joint-stock company form of corporate ownership and the first fully functioning stock exchange in Amsterdam. This innovation enabled large numbers of investors to pool rather small individual sums of money to underwrite a new enterprise.
- ◀ The key aspect of a joint-stock company is that each investor can lose only the amount of money the individual puts into the company. The collective resources of individual investors combined with limited personal liability makes it possible to gather large sums of money to build, for example, large factories with complicated machinery and equipment.



The U.S. center of capitalism is New York, symbolized by the New York Stock Exchange. But New York was not the original name of the European settlement at the mouth of the Hudson River on the island of Manhattan. Henry Hudson was a Dutch explorer, and Manhattan was purchased from the Native American inhabitants by the Dutch. So, New York was first known as New Amsterdam.

- ◀ In early market economies, most production was small-scale and accomplished with a few simple tools. The individual baker or shoemaker produced one item—or a few at a time—and did not need large amounts of money to start or maintain the business.
- ◀ What made large-scale British industrial capitalism different was massive factories producing thousands of items a day. Because no individual could raise all the funds necessary for these large-scale enterprises, the joint-stock company was vital to raise the necessary funds.

- ◀ An individual investor with a few shares of stock typically could sell these shares fairly easily and get out of any enterprise the investor deemed too risky or possibly unprofitable. This was made possible by a functioning stock market, where buyers and sellers of stocks could trade shares of companies on a regular and regulated basis. And it further reduced the risks of ownership.
- ◀ But the honesty of stock market participants—and the true value of the companies they own—is a continuing problem in the functioning of most stock markets.
- ◀ The Dutch began the process of regulating the companies that could sell their shares on the Amsterdam Stock Exchange. But even today, this regulatory process has not been perfected—and never will be. So, stock market crises have continued to disrupt capitalist economies and create economic instability. It's one of the chief problems of every capitalist economy.
- ◀ The payments system is also a necessary institution for advanced capitalist economies. Paying for goods and services, paying for raw materials and labor, and borrowing and lending money all historically depend on a banking system that is both sound and dependable.
- ◀ The northern Italians of the late Middle Ages invented modern banking and perfected it as merchant capitalism began to grow. But even with central banking systems and government deposit insurance systems—two innovations of later centuries—banking crises persist even today.

## Building Industrial Capitalism

- One of Britain's main advantages in building industrial capitalism was that by the beginning of the 18<sup>th</sup> century, it was the largest single market in Europe. Britain's single market had a much larger customer base than elsewhere in Europe. So, British manufacturers could enjoy the benefits of mass production—which was the key to lower unit costs of production and lower prices for individual goods. This gave British capitalists a great competitive advantage compared to other European economies.
- Another key advantage for British capitalists was the Royal Navy. By the beginning of the 19<sup>th</sup> century, Britain had the largest and most modern navy in the world. Its sailors and fleets could protect British ships carrying the goods of British manufacturers around the world.
- One of the important institutions that Britain created was parliamentary democracy and the rule of law regarding property rights. The English first began to limit the power of the central government with the Magna Carta of 1215: the concession by King John to his nobles that subjected the sovereign to the rule of law and identified certain liberties as rights belonging to all free men. A further limitation on capricious governmental power was the Glorious Revolution of 1688 and 1689 and the execution of England's Charles I.
- Property rights are crucial to a market economy. Manufacturers, merchants, bankers, investors, and property owners must feel secure that their property, assets, money, and resources won't be taken away at the whim of the government, but rather only after an independent judicial process concludes that some law or regulation has been violated.

## British Political Economy

- ▶ The most important British contribution to the development of industrial capitalism was British political economy.
- ▶ The Scottish philosopher, historian, and economist David Hume and the economist Adam Smith were both intellectual leaders of the Scottish Enlightenment. This period of revolutionary thought about economics, politics, and the just order of a commercial society lasted from roughly 1748 to 1789.
- ▶ Smith and Hume laid out the basic preconditions for a just and efficient commercial society based on private property and market exchanges. Their ideas were antiroyalist, antitraditional, and inherently democratic. They believed that people should be free to choose their own occupations and govern their own purchases and sales.
- ▶ If many people could choose to be shoemakers, for example, they would compete robustly for customers, and good shoes would be produced at fair and competitive prices. Furthermore, this competition would drive the search for better and more efficient ways of producing current goods and lead to the development of new goods and services finding a profitable market.
- ▶ The English political economist David Ricardo provided an intellectual argument for free trade and international competition. In his groundbreaking book, *On the Principles of Political Economy and Taxation*, published in 1817, he introduced the concept of comparative advantage, which remains one of the most important principles of economic theory.

- ◀ Ricardo explained that countries should specialize in the products they produce with the lowest opportunity cost. In other words, whatever choice an economic actor makes about production, he or she will necessarily sacrifice other opportunities as a result of the investment and ingenuity required to make the product of choice. Ideally, in the interests of efficiency, your choice should come with the lowest cost.
- ◀ While there are some exceptions to this principle, such as national defense, it's still an approximation of why certain countries specialize and export certain products while importing the products that are very costly for them to produce.

## The Labour Party

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- ◀ By the 1800s, Britain was the world's foremost industrial power and its richest country. The cities of Manchester, Birmingham, Sheffield, and London were all growing rapidly and pulling in rural citizens to work in factories near urban areas. The port cities of Bristol and Plymouth—and shipyards in the north—also grew commensurately.
- ◀ With a growing urban working class, the problems of unequal incomes, poverty, industrial accidents and death, and urban crime quickly followed. Popular agitation and campaigns for improvement in the lives of factory workers began around 1845, when Karl Marx's collaborator and fellow revolutionary Friedrich Engels wrote *The Condition of the Working Class in England*, which provided graphic details about the long and dangerous work of factory laborers and the slum conditions in which they lived.

- ◀ The first British organized labor movement, the Trades Union Congress, was formed in 1868. Eventually, this gave rise to a political party based on the British labor movement: the British Labour Party, one of two principal political parties in the country today.
- ◀ The Labour Party's original program called for the abolition of capitalism and its replacement by a socialist economy, though it advocated peaceful change through victories in democratic elections rather than revolution and violent overthrow of the existing government.
- ◀ In 1924, for the first time, the Labour Party won the most votes in a national election—but not a majority—and led a governing coalition for less than a year, partially as a result of the disaster of World War I. But the Labour Party swiftly lost again, in the next election, to the Conservative Party.
- ◀ The Labour Party returned to power with the onset of the Great Depression, ruling from 1929 to 1931. The Depression was an economic blow to capitalist economies and its workers and also a challenge to the idea that capitalism was the most efficient and dynamic economic system.
- ◀ With millions of workers unemployed, businesses bankrupt, financial institutions failing—and farmers thrown off their land—political movements and parties that advocated an alternative to capitalism found newfound acceptance and support.
- ◀ In the 1930s, the Labour Party began to implement Keynesian macroeconomic policies of fiscal stimulus and a greater social safety net. These measures included government funding of public works, extended social welfare benefits, and taking Britain off the gold standard to allow for a more flexible monetary policy.

- ◀ After World War II, the British Labour Party won a huge electoral victory and mandated for much more comprehensive social welfare programs. With this, Britain began the National Health Service, unemployment compensation, public housing construction, labor union rights, mandatory holidays for workers, and nationalization of some industries.
- ◀ Although the Labour Party never instituted a Soviet-style state takeover of all private property and businesses, it did nationalize several key enterprises, including British Telephone, British Petroleum, and the expansion of the British Broadcasting Corporation (BBC) into television and radio.

Perhaps the most important cultural force of post-World War II Britain was the British Invasion of rock-and-roll music led by the Beatles and the Rolling Stones. Although their first recorded songs were adaptations of classic American rhythm and blues, the Beatles and the Stones came to embody some of the most important cultural influences in the world during the 1960s.



- ◀ In other words, Britain evolved one of the world's oldest, most orthodox free market economies into a much-modified capitalist system with some government ownership and control. This was a far cry from the economy advocated by Adam Smith and the thinkers of free market capitalism.
- ◀ It had some positive benefits. British incomes and living standards became much less unequal. The health and housing conditions of the average British worker improved markedly. The cultural life of the British citizen arguably grew richer, through the programs of BBC television, radio, and the British film industry.
- ◀ After less than half of a century, the short-lived era of Labour Party socialism ended with the election of Margaret Thatcher and the Conservative Party in 1979.

### Readings

DICKENS, *Hard Times*.

ENGELS, *The Condition of the Working Class in England*.

### Questions

- 1 The British created industrial capitalism, but did they create all the necessary institutions for its development?
- 2 David Ricardo thought that free trade would be good for British workers and capitalists. Who did he think it would harm?



## Lecture 5

# American Capitalism: Hamilton and Jefferson

**A**LTHOUGH THE SPANISH WERE THE FIRST EUROPEANS to settle and explore the Americas, the Dutch and the British gave the future United States of America the institutional structures that were so beneficial for its own brand of capitalism. The early Dutch brought with them the key institutions of banking, stock markets, and insurance. While the Dutch created modern finance, the British established private-property rights—on which modern capitalism is based—and the common law legal system of contracts, which is also necessary in a capitalist society. ♦

## Economy of the American Revolutionary War

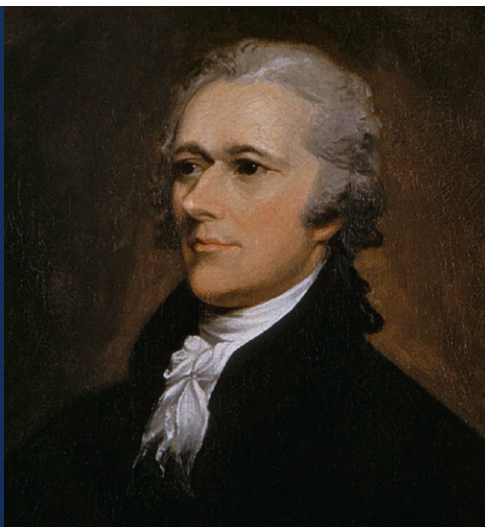
- ▶ The author Kevin Phillips draws a clear historical line between the mid-17<sup>th</sup>-century English Civil War and the subsequent economic and political history of the British colonies in America; and the nascent United States of America.
- ▶ The American Revolutionary War emerged from a continuing sense of restriction felt by the New England settlers against their colonial rulers. The British monarchy, and British capitalists, wanted the new Americans to fulfill the usual function of a lesser-developed colony—that is, the American colonies should provide raw materials for the industries of the British capitalists and the American colonists should buy the finished manufactured goods of the British industrialists.
- ▶ This is the classic recipe for keeping colonial land underdeveloped and dependent and for concentrating higher profits earned from producing finished manufactured goods in the home country.
- ▶ Furthermore, British colonial policy dictated that American raw materials and other exports should be shipped only on British vessels. This created a monopoly for British shipping. It's a basic law of economics that monopolies charge higher prices, and provide poorer service, than businesses who face serious competition.
- ▶ In addition, the British Crown was imposing taxes on the Americans' own business activities. The taxes were not particularly onerous, but they did make American goods more expensive and gave British goods an added advantage.

- ◀ Maybe the most serious British restriction was the passage of the Quebec Acts, which extended the border of the Quebec territory into the Ohio territory and Mississippi Valley, reinforcing the Proclamation of 1763 that forbade American colonists from settling lands west of the Allegheny Mountains.
- ◀ The Virginian surveyor, soldier, and aspiring colonial officer George Washington had plans to expand his farm farther west and profitably exploit the potential of this property.
- ◀ Fortunately for the rebellious American colonists, the French monarchy at the time hated the British more than they hated uprisings against monarchs. The French gave the American revolutionaries support and superior forces when combined against the British.
- ◀ After the success of the American Revolution, the expansionary nature of American capitalism was unshackled to push westward, farther and faster. To make sure that American manufacturing would flourish, Alexander Hamilton, the first U.S. Secretary of the Treasury, established policies to nourish American industries.
- ◀ Language known as the Commerce Clause was inserted in the Constitution to help support as large a market as possible for the output of American businesses. Larger and larger production runs—and an increasing scale of production—are hallmarks of successful capitalist enterprises, and the clause prevented individual states from hindering or blocking the sale of goods from one to another.
- ◀ Additionally, to protect American industry from competition by the leading British and other European capitalist powers, Hamilton advocated a system of high tariffs on imported goods,

thus protecting American producers. As a consequence, the United States had one of the highest tariff rates from the nation's beginning until after World War II.

- ▶ Hamilton also insisted on the federal government assuming the debts of the individual states and issuing federal debt certificates. Although it's fashionable today to oppose any kind of federal debt, there are some good reasons for it. Mainly, it creates low-risk assets for savers and investors and supports the formation of a bond market—a necessary financial component of a modern capitalist economy.
- ▶ Hamilton also wanted a central bank that would be an issuer of money and a lender of last resort. He lost that battle to the Anti-Federalists. The United States did not get a true central bank until 1913—after the panic of 1907—with the creation of the Federal Reserve System.

In modern international economics, one argument for tariffs in developing countries is the “infant industry” argument to protect new industries. Alexander Hamilton invented this phrase.



*“I am for a government rigorously frugal and simple, applying all the possible savings of the public revenue to the discharge of the national debt.”*

—JEFFERSON



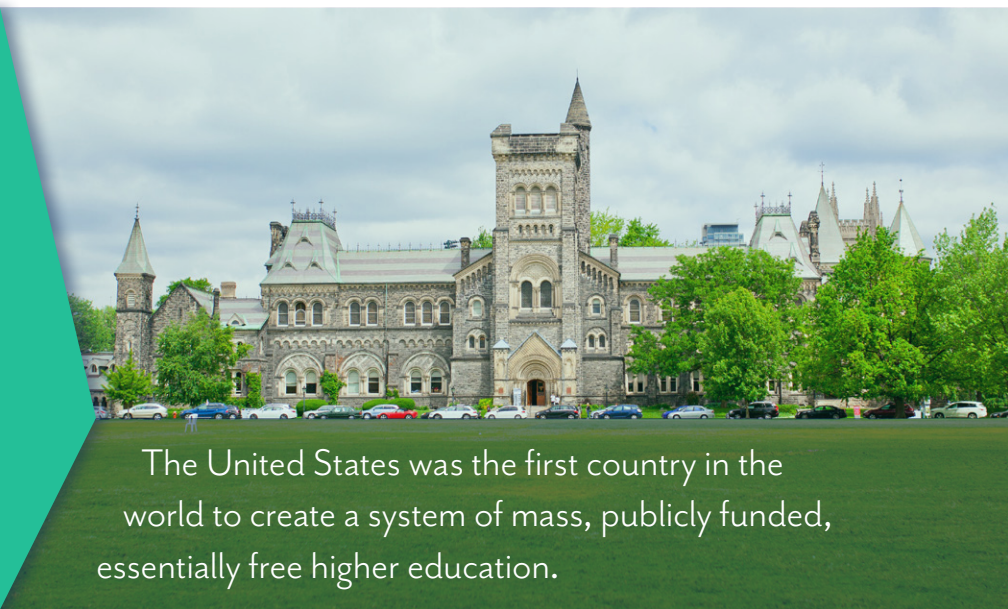
- ◀ The original Federalist era in the United States ran from 1789 to 1801, concluding with the end of John Adams’s sole term as president. He was succeeded by his rival, Thomas Jefferson, who gave rise to the Jeffersonian view of government: “rigorously frugal and simple.” Jefferson reduced the size and scope of the federal government and paid off its debt.
- ◀ But then, the Napoleonic Wars of 1803 to 1815—against France’s European rivals—gave Jefferson the opportunity to purchase the French-held Louisiana Territory, an 828,000-square-mile landmass that doubled America’s footprint and set in motion the creation of 15 new states.
- ◀ At the time of the Louisiana Purchase in 1803, Napoleon was fighting nearly every other European power, and he needed money to fund his war efforts. So, he sold French lands reaching all the way to the Rocky Mountains and from the Gulf of Mexico to Canada. This greatly increased the potential scope of American industry and agriculture.

## Economy of the American Civil War

- ◆ But the new lands also planted the seeds for conflicts that culminated in the Civil War. Were the new states created from the Louisiana Purchase to be free states or slave-holding ones?
- ◆ If the new states were to extend slavery, then the new senators and representatives of these states would invariably vote to maintain slaves as property, and slave-based agriculture likely would dominate the American economy. But if the new states were free states, then their senators and representatives would almost certainly vote to abolish slavery.



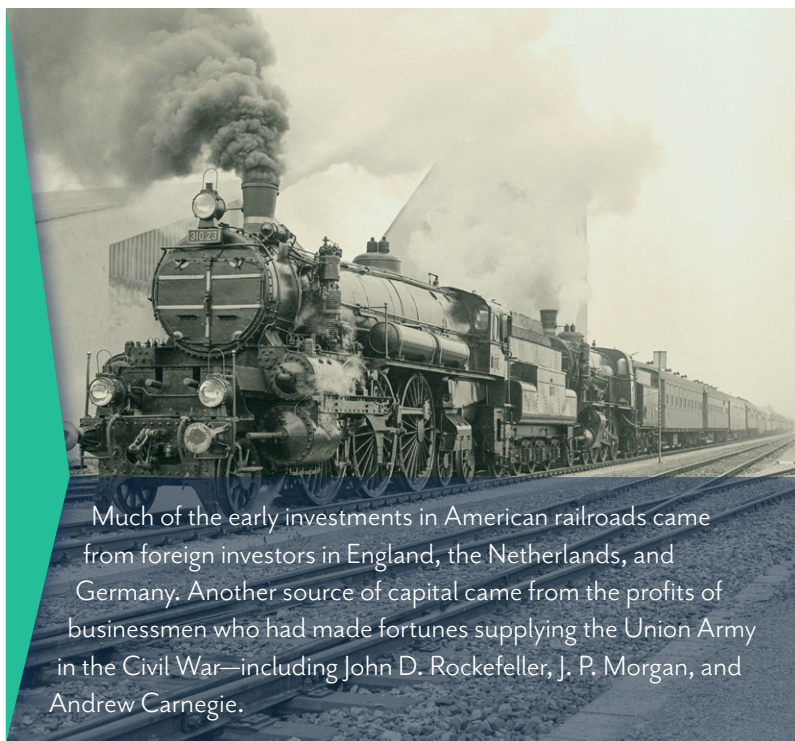
Private property is almost always the most efficient agricultural system for the production of food and raw materials. Farmers seem to produce best when they own their own land and reap the economic rewards of their efforts.



The United States was the first country in the world to create a system of mass, publicly funded, essentially free higher education.

- ◀ During the Civil War that followed—with Congress in the hands of radical Republicans and no Southern conservatives sitting in the Senate or House of Representatives—Congress passed two of the most important pieces of legislation in the development of American capitalism: the Homestead Act and the Morrill Act, both passed in 1862.
- ◇ The Homestead Act provided for the free distribution of new lands west of the Allegheny Mountains. By limiting the size of the property and distributing it for free, millions of new property-owning farmers were created. This was an enormous extension of private property and solidified the American economy as a system of widely held private property with significant political support.

- ◇ The Morrill Act established a system of land-grant colleges in the newly created western states. Each state university was given an allotment of land that was to be the main source of revenue for the college. Tuition rates would be low or nothing. Many economists who specialize in economic development believe that the high level of human capital possessed by American workers was the most important factor in the rise of the U.S. economy to become the world's richest in subsequent decades.
- ◀ After the Civil War, the American capitalist economy resumed its westward expansion.
- ◀ One of the first significant postwar actions of the U.S. government and the federal army was the removal of the Native Americans from their traditional lands to make room for private-property agriculture and also for the coming of the railroads, which were a great stimulus to American capitalist development.
- ◀ With the development of the railroads, new industries were created and existing industries were expanded. Customers all over the United States could order all manner of goods from a catalog and send their orders through the mail, which was carried in railway cars.
- ◀ The development of large American capitalist industries also created some serious problems. These problems were related to the industries' powerful size and uncompetitive behavior.
- ◀ Soon, big oil companies, large steel companies, and expansive food companies combined into trusts that monopolized markets. This led to increases in prices and poor-quality goods and services.



Much of the early investments in American railroads came from foreign investors in England, the Netherlands, and Germany. Another source of capital came from the profits of businessmen who had made fortunes supplying the Union Army in the Civil War—including John D. Rockefeller, J. P. Morgan, and Andrew Carnegie.

## A Growing Economy

- ◀ To counter the excessive developments of capitalist society and its Gilded Age, the Progressive movement was started and had some significant successes in curbing the abuses of the dominant market power of the trusts.
- ◀ The Interstate Commerce Commission was created in 1887 to regulate the railroads and ensure fair pricing for transportation services. President Theodore Roosevelt pushed through

legislation that created the Food and Drug Administration in 1906 to regulate the production and distribution of food products. The Federal Trade Commission was created in 1914 to police the competitive situation in the American economy and to prevent the buildup of monopoly power by large corporations.

- ◀ In the long run, these policies helped make the American economy more competitive and more beneficial to consumers and small businesses. But none of these reforms fully addressed another recurrent problem of capitalist economies: the persistent cycle of boom and bust.
- ◀ Before depressions and recessions were known by those terms, they were called panics. Panics are a macroeconomic problem: They cause a general decline in the entire economy, not in just one sector. With capitalism and some of its excesses accelerating at full throttle through the second half of the 19<sup>th</sup> century, there were panics in 1873, 1893, and 1907.
- ◀ The panic of 1907 culminated in a financial crash that led to the creation of the Federal Reserve System and of a central bank to monitor the money supply and interest rates. But the problems of system-wide collapses of capitalist economies was not fully addressed until the time of the Great Depression of 1930 and later again after World War II.
- ◀ Following World War II, the United States took up greater leadership at home and around the world, most clearly among its European allies. It sought to develop more concentrated and sophisticated efforts to prevent, or at least lessen, the damaging effects of depressions, recessions, and other economic dislocations. The belief, then as now, was that capitalism has a much better chance of flourishing—and even surviving—in a growing and stable economy.

## Readings

CHERNOW, *Alexander Hamilton*.

COHEN AND DELONG, *Concrete Economics*.

LINDERT AND WILLIAMSON, *Unequal Gains*.

## Questions

- 1 What key capitalist institutions did American capitalism get from the Dutch? Where were these located in the new American economy?
- 2 Why didn't Alexander Hamilton believe in free trade? What trade policies did he advocate for the new American government?



## Lecture 6

# Utopian Socialism to Amana Microwave Ovens

**W**HILE INDUSTRIAL CAPITALISM BROUGHT IMPORTANT benefits to society in terms of new wealth and opportunity, it also created great problems. The conditions of working-class life in America's big cities during the late 19<sup>th</sup> and early 20<sup>th</sup> centuries were miserable. The unsatisfactory—and often exploitative—conditions inspired many different social and political movements. Some were predominantly religious in nature, seeking spiritual inspiration and solution. Others, such as the trade unions, had economic orientations. Many approaches were a mixture, combining political, social, economic, and religious answers to alleviate the miserable conditions of the increasing numbers of the poor, urban working class. The more religious or philosophical movements got the label of “utopian socialist.” ♦

## Utopian Socialism

- ◀ The term “utopian socialist” was probably first used by Friedrich Engels, the intellectual collaborator of Karl Marx. Engels used the term as a pejorative to make a distinction with the more revolutionary and political movement that he and Marx favored.
- ◀ In 1892, Engels wrote *Socialism: Utopian and Scientific*, in which he promoted the Marxist version of socialism and criticized views and programs that Engels characterized as utopian socialist. The Marxist view of socialism is of an economy with a high level of state ownership, achieved through violent revolution.
- ◀ The term “utopian” signifies a model, or perfect, stage. It does a good job of describing the aims of many people who were attempting to improve humanity’s lot in the face of the evils of industrial capitalism.
- ◀ Many utopian socialists had a strong moral or religious basis for their beliefs. Their religious and moral philosophies were based either on extreme views of the Protestant Reformation or the social gospel tradition of the Catholic Church.
- ◀ The 16<sup>th</sup>-century Protestant Reformation—led by such men as Martin Luther and John Calvin—challenged papal authority and the Bible as mankind’s principal spiritual guides. The gospel tradition refers to the teachings of Jesus through his eyewitness followers and chroniclers.
- ◀ The rise of capitalism was made possible, in part, by the Protestant Reformation and its insistence on the primacy of the individual and the necessity of work and earthly success.



- ▶ The German sociologist Max Weber—in his most famous work—described this connection with a phrase that became the book's title, *The Protestant Ethic and the Spirit of Capitalism*. Weber said that encouraging people to work as individuals for worldly success was one of the key foundations of the rise of capitalism in preindustrial Europe.
- ▶ The teachings of Luther and Calvin criticized the other-worldly focus of the Catholic religion: the Catholics' focus on the afterlife and the excessive time spent in church and on holidays and feast days.
- ▶ After the Protestant Reformation, with its emphasis on literacy and practical vocations, the northern part of Europe became rich, while the southern part of Europe (the Catholic part of Europe) remained quite poor. And it would take the aftermath of World

War II to make the southern part of Germany the richest part of the country. This transformation was the work of the U.S. Army, the Marshall Plan, and Soviet-style socialism.

- ◆ Catholic theology was always more social and communal. It was also much less interested in worldly success for its believers. The role of the Catholic peasant or craftsman was to worship and obey. This philosophy is not the driver of individualistic acquisitiveness in the pursuit of worldly profits.

## Socialist Reformers

- ◆ Although Engels was critical of the utopian socialists, he was not completely dismissive. Instead, he had sincere praise for the efforts of a few early socialist reformers.
- ◆ The first of these early reformers was the French philosopher Charles Fourier, who rejected the entire system of industrial capitalism—factories, cities, and large groups of exploited workers. Instead, he favored voluntary groups of people choosing to live communally in nature and dividing necessary tasks based on their individual passions and desires.
- ◆ Fourier saw industrial capitalism as a system that alienated humans from nature and their own community. Fourier's concept of alienation was later to be taken up by Marx, as one of his first criticisms of capitalism.
- ◆ A much more practical utopian socialist was the Welsh industrialist Robert Owen. Owen was a philanthropist and social reformer who came into possession of a cotton mill located in the village of New Lanark near Glasgow, Scotland. Water mills were

the chief source of power for early British industry, before the advent of coal-fired steam power. At its peak, the mill employed about 2,500 workers.

- ◀ When Owen took over, he was appalled at the poor conditions that the mill workers and their families lived in. He raised wages and established schools for the workers' children. He made sure that the work and home environments of his workers were clean, aesthetically pleasing, and safe. He was a pioneer of urban planning for ordinary workers and citizens.
- ◀ It came as a shock to Owen's fellow industrialists that such efforts could be profitable. His New Lanark enterprise was an example of what contemporary economists call the efficiency theory of wages: Sometimes it is more profitable and efficient for employers to pay workers more than they are required to by labor market conditions. Workers who are paid above the norm may work more efficiently and more industriously and have less absenteeism. And if they are well fed, it's more likely that these workers will be healthier and stronger.
- ◀ The mills at New Lanark continued working until 1968, when they were no longer competitive with textiles and fabrics from newly industrializing countries in the Third World. Low-wage workers from India, Pakistan, Korea, and Taiwan shifted the comparative advantage to their own countries, outstripping the relative worker efficiency of comparatively wealthy Britain.
- ◀ This is one of the Achilles' heels of utopian socialist projects: They remain subject to the ups and downs of the predominantly capitalist world market and the forces of globalization.
- ◀ Today, New Lanark is a tourist destination and a UNESCO World Heritage site.

## The Amana Colonies

- ◀ By far the most famous of the utopian communities established in the United States were the Amana Colonies, which owe their inspiration to German Protestant theology.
- ◀ The Amana movement grew out of opposition to the official Lutheran Church and its increasingly dogmatic theology, which was viewed as becoming increasingly like the Catholic Church: hierarchical, centralized, and dogmatic. The founders of the faith believed that God gave to individuals the inspiration to discover truth; therefore, followers were called Inspirationalists. And they were persecuted by the official Lutheran Church.



One of most impressive modern utopian social organizations is the Mondragon Corporation in Spain, which employs more than 70,000 workers and generates about \$12 billion in sales a year. It has been cited as a model for cooperative enterprises all over the world.

Catholic social theology, emphasizing humanist values and a spirit of social solidarity, was the philosophy behind Mondragon.

- ◀ Eventually, in the face of ever-increasing persecution, they decided to leave Germany in 1842 and move to America. At first, they bought land from the Seneca Nation near Buffalo, New York, but after being unable to afford the land they needed to expand their operation and receive more immigrants from Germany, the community moved in 1855 to the newly constituted state of Iowa.
- ◀ The basic form of property ownership in the original colonies was communal. There was no private property. Under Iowa state law, the community had to incorporate as a business. But although the community was incorporated, it had a communistic property system—common ownership, no private property—and a democratic government.
- ◀ The colony was divided into villages that were self-contained communities. Each village had a church, bakery, school, dairy, wine cellar, post office, sawmill, and general store. All workers in community enterprises were compensated in roughly the same amounts. Members were expected to shop at the village stores and budget their spending wisely. Members who became indebted, or ran out of money due to mismanagement, could be expelled.
- ◀ Cooking and eating were communal experiences. There was gender specialization: Women could choose among eight occupations that were traditional female jobs, such as cooking, gardening, and laundry, while men had their choice of more than 30 jobs. Children stayed with their mothers until the age of two, and then they were sent to school.
- ◀ The Great Depression intervened and crushed the economic viability of the Amana Colonies in 1931. Just as millions of American businesses and farms were bankrupted by the Depression, so Amana had to reorganize to survive.

- ◀ Two different institutions emerged. One was given the task of tending to the spiritual needs of the community. This was the Amana Church Society. The other entity was created as a joint-stock company to manage the colonies' land, industry, and community services. This was the for-profit Amana Society, which exists to present day, producing bread, meats, furniture, clocks, and woolens.

## The Amana Radarange Microwave Oven

With the repeal of Prohibition in December 1933, one worker and stock owner of the Amana Society suspected that there would be great demand for beverage coolers and refrigeration. The Electrical Department of the Amana Society was formed to meet this demand.

The Electrical Department was sold in 1965 to the Raytheon Company, which was developing radar technology for the Department of Defense. By accident, a Raytheon scientist discovered microwave cooking—by putting a bag of popcorn near a magnetron, a high-powered vacuum tube that generates short radio waves called microwaves. The scientist noticed the kernels began to pop. And this led to the Amana Radarange.



## Readings

ENGELS, *Socialism*.

TAYLOR, *Political Ideas of Utopian Socialists*.

WHITE AND WHITE, *Making Mondragon*.

## Questions

- 1 What ideas and policies of the reformer Robert Owen might be beneficial for capitalist managers?
- 2 What do you think are the main pros and cons of the Mondragon Corporation? How does Mondragon benefit its worker/members?



## *Lecture 7*

# The Bolsheviks: Lenin, Trotsky, and Stalin

**O**N JULY 16, 1918, SEVERAL MEMBERS OF THE RUSSIAN royal family were murdered by Bolshevik revolutionaries. The royal family patriarch, Tsar Nicholas II, had been deposed months before his murder, ending 300 years of Romanov family rule. Revolution was under way across all segments of society—the military, radical leftists, and elites—with many of them fleeing. What would follow is the creation of a vast new state known as the Soviet Union, at a time when World War I had exhausted the Russian people and led to the deaths of millions of Russian peasants conscripted into the tsarist army. ♦

## Vladimir Lenin

- Two revolutions occurred in Russia in 1917. The first was the February Revolution that deposed Tsar Nicholas II while maintaining the Romanov dynasty and Russian participation in the war. The second was the October Revolution led by the Bolsheviks under Vladimir Lenin, which founded the Union of Soviet Socialist Republics as a communist state under the control of one party.



- The Bolsheviks seized power in St. Petersburg and Moscow but were attacked by opposing forces known as the White Army in a civil war that lasted from 1917 to 1922.



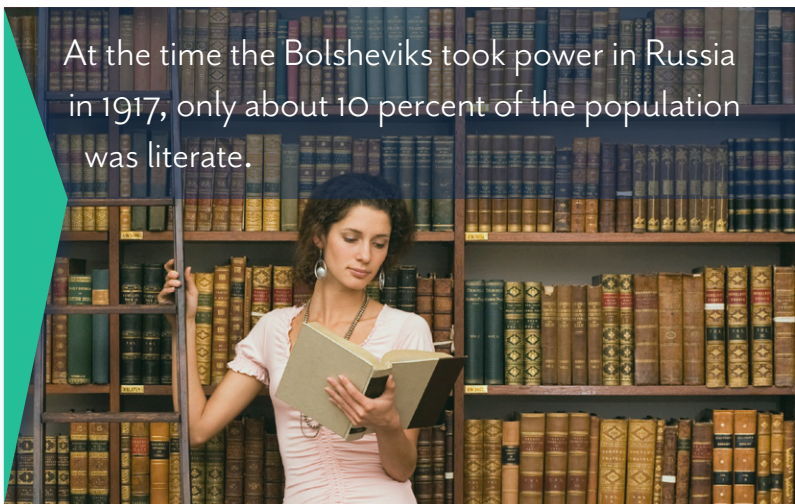
Under the tsars, Russia was on the old Julian calendar. After the Bolshevik Revolution, the Soviet Union joined the rest of the world in using the Gregorian calendar, under which the date of the Bolshevik Revolution was November 7, 1917.

- ◀ Karl Marx left no detailed description of what a real, functioning communist economy would look like. Consequently, Vladimir Lenin and his fellow Russian Bolshevik communists had to make up their new economic system when they seized power.
- ◀ The Bolsheviks—who constituted the majority faction of the Russian Social Democratic Party that had seized power—decided on a system of direct control over the economy. This was eventually called War Communism, and for many revolutionaries, it was what their ideal economy would look like even in peacetime. War Communism lasted from 1917 to 1921 and was a system of complete state ownership and control of all important economic sectors.
- ◀ Because the Bolsheviks had taken over a society with very few factories and industrial resources, their labor force consisted of illiterate peasants who had to be recruited from the countryside.
- ◀ Furthermore, the Bolshevik wing of the Russian Social-Democratic Workers' Party that had emerged victorious in the larger political struggle against the old Romanov monarchy—and against the party's Menshevik wing—was led by political personnel and philosophical thinkers such as Lenin. They were not experienced or skilled at economics and business. The Bolsheviks also tended to be city boys who knew very little about farming and agriculture.
- ◀ Meanwhile, many of society's elite—scientists, managers, and industrialists—had already fled during the civil war. In this, we begin to understand the cause of some of the continuing difficulties of Soviet agriculture throughout the entire history of the Soviet Union.

- ◀ The Bolsheviks' economic and political philosophy positioned them as enemies of private property and as hostile to factory owners and land owners. And this antagonism was one of the reasons the Bolsheviks decided that they had to take direct control over the country's means of production.
- ◀ Many observers and scholars who study the Soviet system believe that dictatorship is inherent in socialism and communism. Others contend that the Soviet dictatorship arose out of the unique conditions of Russian and Soviet society.
- ◀ The argument that dictatorship grew out of the Soviet Union's unique circumstances is based on several particular forces in prerevolutionary Russia and in the newly created society.
- ◀ Tsarist Russia was nobody's idea of a modern democracy. The tsar was considered a divine ruler, and no protest or criticisms of the policies of the divine ruler were tolerated. Secret police spying on citizens, exile to Siberia, and banishment were not creations of the new Bolshevik rulers of Soviet Russia but instead were instruments of dictatorial rule employed by the Russian aristocracy.
- ◀ Any political opposition or independent thinking in prerevolutionary Russia had to be done in secret and underground. There was no history of open, public, democratic debate. Anyone outside your group could be spies, enemies, or police agents. Tight control over any group by its leaders was necessary to preserve the group from outside harm.
- ◀ Not only did the Bolsheviks have to fight against domestic enemies in the White Army, but for a brief period of time, British and America forces—although exhausted by the horrors of World War I—also fought in Russia against the Bolshevik Red Army.

- ◀ After the Red Army and the Bolshevik leadership emerged victorious in the political and military battles unfolding across the new Soviet Union, they still faced the almost impossible task of providing food and the basic necessities to a desperate population exhausted by war.
- ◀ Furthermore, Lenin and the other Bolshevik leaders also realized that they did not have sufficient personnel or trusted comrades to oversee the economy. Many Bolshevik leaders and partisans had been killed in the civil war. And Russia is such a vast country that it stretched across 11 time zones.
- ◀ The Bolsheviks had no alternative but to relax their initial attempt to command the new Soviet economy, because they had limited ability to manage it. This relaxation of control meant that individual landowners initially could make their own decisions as to what to grow, how to grow it, when and where to market their produce, and what to charge for it in agricultural markets that were now permitted.

At the time the Bolsheviks took power in Russia in 1917, only about 10 percent of the population was literate.



- ◀ The allowance of private farming was a significant ideological retreat for the new Soviet Russian communist leadership. As a result, a leadership that had promised to eliminate the inequalities of private property now had to allow some private property.
- ◀ Along with private agriculture, the new Soviet leadership also had to allow small private retail and manufacturing enterprises to exist, such as bakeries and furniture shops. This new system of relaxed control over the economy was given the label of the New Economic Policy (NEP), and it was in force from 1921 to 1928.
- ◀ Along with a somewhat relaxed approach to economic control, this was a time of open debate and artistic experimentation. Sergei Eisenstein revolutionized the making of modern film, Kazimir Malevich broke new ground in art and theory with a series of sculptures called the *arkhitektons*, and Vladimir Mayakovsky and Anna Akhmatova wrote modern poetry.
- ◀ Lenin died in early 1924. Prior to his death, an unsuccessful assassination attempt had left him weak and unable to vigorously exert his command over Bolshevik personnel. This set the stage for one of the most important and prolonged conflicts in the Soviet leadership: the Great Industrialization Debate.
- ◀ The Great Industrialization Debate concerned how long private ownership should be allowed to continue and how much economic freedom would be given to private Russian landowners and farmers. There were also debates about democracy, and, most importantly, there was the struggle to replace Lenin.
- ◀ One faction, known as the Right Opposition, favored a long run for the NEP and a slower road to true communism. A leader of this faction was Nikolai Bukharin, the Bolshevik leader most knowledgeable about economics and economic development.

## Leon Trotsky

At the opposite extreme from the Right Opposition were the leftists. The left wing of the party was led by Bolshevik intellectual Leon Trotsky, the most famous Bolshevik after Lenin. Trotsky had written several books on politics and revolution, as well as a famous three-volume history of the Russian Revolution.

Like Lenin, Trotsky spent several years outside of Russia after being banished by the tsarist government for revolutionary activity. While Lenin went to Zurich, Trotsky spent most of his prerevolutionary exile in the salons of Vienna.



Born as Lev Bronstein, Trotsky used his family name while hiding in Vienna.

- Trotsky opposed the continuation of the NEP and advocated a much swifter transition to complete communism. One of the developments leading to this conclusion was the so-called scissors crisis, which was the result of an increase in farm prices and the resulting enrichment of some successful farmers.
- The leftist opposition assumed that these rich farmers—whom the Bolsheviks labeled kulaks—would keep getting richer and richer. If, as the leftists envisioned, agricultural prices increased, this would lead farmers to plant more crops, eventually increasing

the supply of farm products and bringing prices back down. This is an example of the new Soviet leadership's fundamental misunderstanding of how markets work.

- ◀ According to the Left Opposition, personified by Trotsky, the kulaks might eventually become rich and powerful enough to oppose the Soviets politically, leading to a counterrevolution and the establishment of a capitalist society.
- ◀ The left advocated taxing the kulaks to secure the funds necessary to finance rapid investment in heavy industry and manufacturing. The left also said that the state should directly manage and procure key agricultural outputs, either by direct requisition or establishment of state-owned agricultural enterprises.
- ◀ The Left Opposition feared continuous counterrevolution and attack by hostile foreign powers, and it believed that the Soviet Union needed to acquire its own base of heavy industry to produce the matériel for modern industrial warfare.
- ◀ The left was deeply concerned that the Soviet Union did not have the luxury of time to wait while Russian agriculture slowly and gradually produced the extra output required to generate sufficient economic development.

## Joseph Stalin

- ◀ The Great Industrialization Debate was about the timing and the nature of Soviet economic development. How long could the new Soviet economy remain as a primarily agricultural and mixed economy? The economy was mixed between central control of key parts of the economy but with significant private property and production in the hands of rich kulaks and petty capitalists.

◀ In the middle of these two viewpoints was Joseph Stalin, who was appointed by Lenin as general secretary of the Communist Party, a somewhat secondary position in the intraparty bureaucracy. Stalin was not a leading Bolshevik theoretician or intellectual, but he was a master of bureaucratic infighting and manipulation.



◀ Another factor in Stalin's favor was that his enemies tended to underestimate his skill and ambition. Because Stalin was not among the leaders of the political, economic, and theoretical debates, Trotsky, Bukharin, and others did not consider him to be a leading contender for the leadership role left vacant after Lenin's death.

◀ But they were mistaken. Stalin began his drive for power by allying himself with the Right Opposition and its battle with Trotsky. Stalin had decided that Trotsky was his most formidable rival, due to Trotsky's reputation both inside the new Soviet Union and internationally among communists in other countries.

◀ By isolating Trotsky and eventually driving him into exile, Stalin thereby eliminated his chief rival. Ultimately, Trotsky was assassinated by a member of the NKVD, the Soviet secret police.

◀ After disposing of Trotsky and his followers in the Left Opposition, Stalin turned on Bukharin and the Right Opposition. First, the Right Opposition leadership was expelled from the Soviet Communist Party. Then, they were charged with various

political offenses. And then they were jailed and put on trial. Finally, Bukharin and most of the rest of the opposition were executed following a series of purges and the show trials.

- While the physical elimination of Stalin's opponents was accomplished by the mid-1930s, he had crushed meaningful political opposition to his economic and political plans much earlier. By 1928, Stalin was in complete control of the direction of the Soviet Union. And he oversaw the rapid industrialization of Soviet society that achieved dramatic results at great human costs and that became the template for nearly all new communist governments in eastern Europe, Asia, and Cuba for decades to follow.

### Readings

MASSIE, *The Romanovs*.

NOVE, *An Economic History of the USSR*.

RIASANOVSKY, *A History of Russia*.

### Questions

- 1 What specific historical circumstances led to the Bolshevik Revolution in 1917?
- 2 How did the new Soviet economy “solve” the problems facing Russian society at the beginning of the 20<sup>th</sup> century? At what cost?



## *Lecture 8*

# Soviet Planning and 1,000 Left-Foot Shoes

**J**OSEPH STALIN GAINED COMPLETE CONTROL OF THE Soviet Union and its Communist Party in the four years between Vladimir Lenin's death in 1924 and the initiation of forced collectivization in 1928. In the years to come, the chief instrument that Stalin would use to exercise his all-encompassing control was the five-year plan, which attempted to organize all productive activity in the entire Soviet economy. The plan required hundreds of state personnel to calculate all the input and output requirements of the entire economy. ♦

## The Five-Year Plan

- ◆ The problem of coordinating millions of factories, stores, farms, transport vehicles, and water and power providers was overwhelming. Many observers of the Soviet planning system have remarked that the amazing thing about the Soviet economy was that it worked at all. A separate government agency—known as Gosplan, headquartered in the center of Moscow—was set up to produce the planning documents.
- ◆ The Soviets' five-year plans were broken up into one-year and monthly plans to help make more comprehensible the enormous task of carrying out the nation's planning objectives. Every factory manager, farm director, school principal, hospital administrator, and store manager in the country was given a target goal for each monthly planning period.



If you were a manager of a shoe factory, your monthly plan goal—or “output target”—might be expressed in terms of producing a set number of shoes. A single production run of a single object is the easiest type of production process.

One of numerous jokes about the Soviet economic system is about the shoe factory manager who was given a monthly target of 1,000 shoes. He produced 1,000 size-10 black shoes—for the left foot.



- ◀ A continuing problem of centrally planned production is the difficulty of anticipating and satisfying the need for many different styles and forms of products, especially consumer products that will end up meeting the requirements of real people.
- ◀ The most important person in the production process was the factory or farm manager, usually called the enterprise director, who was subject to a rather complicated system of controls. The layout of this system of control and planning was to be a template for nearly all communist economic and political systems throughout the world.
- ◀ At the top was the Communist Party. Its leader was the general secretary of the Central Committee of the Communist Party. In the Soviet Union, this position of power was created by Stalin, and it remained a station of power in the USSR through the rule of Mikhail Gorbachev, the last general secretary.
- ◀ The general secretary presided over the regular meetings of the politburo—a small group of party leaders who decided the most important questions for the economy and society at large. The politburo and the general secretary were elected by the Central Committee, which in turn was elected at a party congress that convened every few years. Members of the Communist Party were the only citizens who were allowed to vote in these all-important elections.
- ◀ In local towns, factories, farms, schools, and stores, party members were the eyes and ears of the party to make sure that the plans and decisions of the top leadership were carried out. Each enterprise director was closely watched and checked on by the party member, or members assigned to his particular enterprise. Depending on the importance of the enterprise, the director himself might also be required to be a member of the party.

- ◀ This system of party leadership was the main mechanism of political control over the economy. However, there was also a nominally independent government system. The government of the Soviet Union was led by a premier, or prime minister, who was elected by the Supreme Soviet—ostensibly, the governing legislature of the country.
- ◀ In the early days of the Soviet Union and the Russian Bolshevik Party—that is, the Russian Social-Democratic Party—the new economic and political system was supposed to be governed by elected councils of workers and peasants. This idealized democratic system was run by elected representatives of ordinary workers and farmers.
- ◀ To pay tribute to this ideal, the Supreme Soviet was established to give the appearance of a democratically elected government. In reality, the Supreme Soviet had no independent power, and the elected representatives had to be approved by the Communist Party.

The Supreme Soviet met for only a few days every several years, and all its votes were unanimous; of course, no democratically elected and powerful legislature has anything close to unanimous votes.



- ◀ Below the Supreme Soviet was the council of ministers, the personnel charged with running the individual components of the Soviet planned economy. Each minister was in charge of a particular branch of the economy. Each enterprise was a component of a particular ministry, and each enterprise director would answer to his or her boss at the appropriate ministry.
- ◀ The minister of state planning was given the task of developing each component of the five-year plans. An enterprise director was given the part of the plan that related to his or her ministry. The minister of state would then decide how the objectives of the plan would be allocated among the various enterprises within the ministry.
- ◀ To demonstrate the superiority of the Soviet economy—and, by implication, the superiority of Stalin—gigantic enterprises were created. This would lead to all kinds of problems, such as communication and coordination of enterprise functions.
- ◀ Capitalist enterprises suffer from this problem as well, but eventually, the higher costs of production will force a capitalist firm to scale back and cut costs. There was no such cost pressure at work in the Soviet economy to limit the size of an enterprise.
- ◀ That's because most Soviet enterprises were organizationally linked to worker apartment complexes, schools, grocery and clothing stores, medical clinics, sports, and cultural centers. Each of these providers of goods and services supported enterprise workers and their families.
- ◀ So, in the Soviet system, where you worked determined almost everything about your daily life. Access to apartments, schools, retail goods and services, sports, and culture was all under the control of the enterprise director and served as a tool to organize and motivate workers.

- ◀ Soviet workers were also organized into trade unions. But unlike labor unions in capitalist countries—which often are the antagonists of corporate bosses and managers—Soviet trade unions were yet another means for the Communist Party to exercise control. Trade unions usually had control over issues such as workers' pensions and vacations.

## State Farms and Collectives

- ◀ Soviet agriculture was organized into state farms or collectives. Collective farms were theoretically run by all members of the collective, but in reality, the key decisions were made by the farm manager and his Communist Party colleague.



Farm machinery drivers were elite workers in Soviet agriculture, so tractor and combine drivers were among the highest-paid farm workers.

Before Mikhail Gorbachev went off to Moscow to study law at Moscow State University, he worked as a combine driver in Stavropol, in southern Russia, where he grew up.

- ◀ Collective farm members were paid according to revenues raised, including sales to the state. Member incomes would vary according to hours worked and the skill level of their particular occupation.
- ◀ State farms were managed directly by an appointee of the ministry of agriculture and were supposed to be run on an industrial basis, just like a city factory. State farm workers received hourly pay, just like an urban factory worker.
- ◀ State and collective farms also provided housing, education, medical care, and basic consumer goods and services—just like industrial employers in the cities.
- ◀ At the beginning of the Soviets' five-year plans in the early 20<sup>th</sup> century, agriculture was crucial to the country's industrial development.
- ◀ Stalin had decided that the Soviet Union must industrialize rapidly if it were to survive as the lone communist society surrounded by capitalist enemies. In the Great Industrialization Debate, there were two camps: the Right Opposition, led by Bukharkin, who advocated a gradual approach to development; and the Left Opposition, led by Leon Trotsky, who advocated much more rapid industrialization, concentrating first on heavy industry.
- ◀ Essentially, Stalin adopted the ideas of the Left Opposition and implemented these ideas and proposals ruthlessly. In the beginning, Soviet agricultural had to perform four critical functions: provide food for a growing urban and industrial labor force, supply some of its workers for the growing industrial force, provide raw materials for Soviet industrial production, and deliver exports that would earn foreign exchange.



The United States—and, for that matter, every advanced industrial economy—saw the majority of its workers move from farms to factories amid urbanization and industrialization. But the process in the United States took almost a century. The Soviet Union made this transition in less than 10 years.



- ◆ One tiny pocket of private agriculture existed on most Soviet collective and state farms. These were the private plots allocated to almost every member or worker. On these very tiny plots of land—only a few yards square—Soviet farm workers would grow a few potatoes, and maybe some cabbage, and raise a few chickens. This meager output was a primary food source for many Soviet agricultural workers.
- ◆ Even up to modern times, Soviet industrial workers in the cities were also given access to their own private plots. This concession to private property, and individual initiative, was necessary to avoid mass starvation, as nearly all of the output of state and collective farms was delivered to state agencies so that state planners could achieve their larger objectives.

- ◀ Many private landowners resisted Soviet efforts to force them into collective or state farms. Some were shot or imprisoned, their machinery and their livestock seized by the state. The rash and irrational organization of Soviet agriculture was to plague the Soviet Union with serious food and crop problems throughout the country's history.

## Education

- ◀ To develop the more skilled workers required to industrialize, the Soviet Union had to build primary and secondary schools to teach the basics of reading, science, and arithmetic.
- ◀ The Soviet Union provided primary (and, later, secondary) education to nearly all of its citizens, but university education was rather rare and very specialized. The most important areas of study in Soviet universities involved production questions. Therefore, engineering, math, and science were the critical departments, and the most prestigious.
- ◀ The university system was fundamental to Soviet class structure. Where you graduated from determined where you would end up in Soviet society and in the Soviet hierarchy, including your job, apartment, medical care, vacations, and status.
- ◀ Property or financial wealth could not be passed on, or inherited, in the Soviet Union for the simple reason that there were no financial assets or private property. What could be bequeathed to your children—if you were a high-ranking Soviet official—was preferred access to a good university.

- ◀ In the Soviet Union, a degree in engineering or the hard sciences was a necessity for appointment to enterprise management and a start up the ladder in an important ministry in Moscow. The only other important university department taught Marxist political theory. If your ambition was to be a top Communist Party official, such academic training was necessary to understand the terminology and beliefs underlying the Soviet political system.



Soviet Russia pioneered one original method of increasing the industrial labor force: bringing women into factory work in large numbers. In fact, the majority of the adult female population was so employed—a first in history. The United States didn't achieve such levels until sometime after 1970.

## The Soviet Economy

- ◆ The Soviet economy was a planned economy, but it did use the basic elements of a monetary system to add another mechanism of calculation and control. That said, banking in the Soviet Union was not part of an independent financial system as you would find in a market economy. The possession of money didn't provide much in the way of purchasing power, or direct command over products or resources, in the Soviet economy unless provided for in the plan itself.
- ◆ The relative unimportance of money, and the critical importance of political position and bureaucratic connection, is the main explanation why Soviet leaders never retired. Retirement meant losing access to the best cars, apartments, clinics, and stores associated with political power and position.
- ◆ For all its inherent contradictions and faults, the early Soviet economy did achieve impressive rates of economic growth. By the time of World War II, the Soviets had achieved an industrial base capable of eventually defeating the bulk of Adolph Hitler's army.
- ◆ Yet the costs in human suffering and death were often hidden, or ignored, by Soviet leadership. Such problems eventually came to the surface.
- ◆ With the fall of the Berlin Wall in 1989 and the collapse of the Soviet Union in 1991, many senior academics found that the knowledge they possessed was worthless in the new postcommunist societies that were developing market institutions and democratic political systems.

## Readings

MALIA, *Russia under Western Eyes*.

SPUFFORD, *Red Plenty*.

## Questions

- 1 How did the organization of the Soviet economy create big problems?
- 2 Why did the one-party state structure of the Soviet Union create strong incentives for Soviet bureaucrats and leaders to never retire?



## Lecture 9

# Economic Consequences of European Peace

**B**EFORE WORLD WAR I, THE GLOBAL CAPITALIST system was extremely open. Most travelers did not need passports, visas, or customs forms, and trade was relatively free. This capitalist world predominantly benefited the rich countries, especially those in western Europe and North America. But it was a world of generally rising standards of living and economic growth. It was also somewhat artificial. ♦



Before World War I, global capitalism centered on Great Britain. British investments created capital around the world. These investments generated profits that flowed back to Britain and financed an increasing standard of living for British citizens, particularly the rich. But the investments also had a downside with major effects on the British economy later in the 20<sup>th</sup> century: While British capitalists were investing funds throughout the world, they were not investing much in domestic British industries. This lack of domestic investment caused competitiveness and a slowdown in British productivity growth.

One of the iron laws of capitalist systems is this: Investment in capital goods drives growth and profits.

## Keynes's Analysis

- ◀ John Maynard Keynes wrote his famous work *The Economic Consequences of the Peace* in 1919 to protest the British and French government positions in negotiations over the futures of the defeated powers of World War I, Germany and Austria.

- Many people wrongly assume that Keynes was some kind of radical, left-wing socialist with a strong anti-capitalist theory. In fact, Keynes found many things commendable about a capitalist society, and he was generally very positive about the benefits of a relatively free market version of capitalism. Keynes, above all, believed that the benefits of a capitalist society should be shared as widely as possible.
- Before World War I, commerce, investment, and travel were freer than they'd ever been—and freer than they are today. This was true globalization. At the same time, Keynes realized that this system was based on unequal distribution of incomes. He emphasized that this system would never have been as dynamic if income and wealth were equally distributed.
- Keynes pointed out that the system was somewhat artificial, based on what he called a double bluff. On one hand, the working classes had to accept that they would get a small share of the wealth and income that they had helped produce. On the other, the rich would receive a disproportionate share of wealth and income—but they would not spend much of it. The rich saved and invested the lion's share of their incomes and thus contributed to the formation of new capital and industries that fueled the growth of the capitalist system.
- Keynes understood the costs and benefits of this arrangement. The cost was the lower standard of living of the working classes. The benefit was the growth of the productive capacity of the capitalist system, which would eventually benefit everyone with greater production and a higher standard of living.

- ◀ This is an iron law of economics: Economic growth depends on saving. Saving, in economic theory, means not using all of society's resources for current consumer goods and services, but rather also using some resources to produce machinery and factories that will in the future produce more consumer goods and services.
- ◀ All economic systems that experience economic growth and development must find some way to create savings and channel those savings into productive investment in capital goods.
- ◀ In the decades before World War I, the bulk of saving was done by the upper classes, who limited their current consumption—to invest in domestic and foreign capital accumulation. This capital accumulation before World War I solved the dire predictions of late-18<sup>th</sup>-century and early-19<sup>th</sup>-century British economist Thomas Malthus, who had forecast that population would generally grow faster than food production and that mankind was thus doomed to continual threats of famine.
- ◀ But investment in agriculture and the cultivation of more land increased the world food supply before 1914 so that more and more people had adequate supplies of food. And the ease of international trade meant that a country's products could be exported all over the world.
- ◀ The American economist Paul Krugman, a winner of the Nobel Prize in Economics for his work in international trade, points out that by 1900, the telegraph was capable of transmitting price information (including prices of stocks, bonds, and agricultural commodities) around the world in a matter of seconds. This speed of economic information was the basis of Keynes's description of easy flows of capital and spending around the world.

- ◀ But a peaceful world of growing capitalism and international trade and travel was halted by the outbreak of the Great War. Although it was mostly a European war, it nevertheless affected the entire world due to the interconnected nature of all economies before the war. International trade and investment ground to a halt, and incomes throughout the world were depressed.
- ◀ This illustrates another facet of modern capitalism: Upheavals in one part of the world have repercussions all around it.
- ◀ At the end of World War I, the victorious Allied powers—Great Britain, France, and the United States—assembled in Paris to conduct negotiations to formally end the conflict. Yet the terms of this peace agreement—known to history as the Treaty of Versailles—set in motion the chain of events that would lead to the Great Depression and World War II.
- ◀ David Lloyd George of Great Britain, Georges Clemenceau of France, and Woodrow Wilson of the United States quarreled over the terms of Germany's surrender. In Keynes's view, their demands promised economic hardship for the defeated Germans that would have negative consequences for the victors as well as the vanquished.

## Balance of Payments

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- ◀ Countries need to both import and export to provide for their industrial development and the well-being of their citizens. A country's exports pay for its imports. If there is a difference between a country's exports and imports—and provided that the difference is not too large—the difference can be financed with international borrowing.

- ▶ The record of a country's foreign transactions is its balance of payments. This is a fundamental accounting that sums up the total outflows and inflows of a country's international transactions.
- ▶ Under the terms of the Treaty of Versailles, Germany was required to make extremely large reparation payments to Great Britain and France for many years. Germany was also required to transfer ownership of all of its railroad stock and merchant shipping. It was required to give France and Britain large amounts of coal and foodstuffs. These very punitive measures were designed to cripple the German economy and make life extremely difficult for the German people.
- ▶ The United States had a different agenda after World War I. The United States had loaned considerable sums of money to Britain and France to help them pay for war materials. At the end of the war, the United States wanted to be paid back for the loans. This would require Britain and France to run large balance-of-payments surpluses in the postwar years. Their exports would have to exceed imports so that they could accumulate the financial assets necessary to repay the United States.
- ▶ The difficulty with this situation is that not every country can run a balance-of-payments surplus at the same time. Total world exports must equal total world imports.
- ▶ If the Germans were going to accumulate the necessary financial assets to meet their obligations, they would have to run large balance-of-payments surpluses for many years. And necessarily, the British and the French would have to run balance-of-payments deficits—at least with Germany.



Many people think that economics is mainly about money, but that's not true. Money is just a means to an end—and a way to measure differing goods, services, and assets.

What economics is really about is people and their lives. In his 1776 book *An Inquiry into the Nature and Causes of the Wealth of Nations*, Adam Smith explained that the real wealth of nations is the goods and services that a nation produces or obtains for its people.

- ◀ For the German people after World War I to have an obligation to maintain large balance-of-payments surpluses meant that German workers had to produce goods and services that would be sent to other countries to earn money for Germany.
- ◀ But after World War I, Germany was a damaged country that had suffered human losses—just as the British, French, Belgians, Americans, and others had incurred great losses. Workers of the age received rather low pay and scraped out a meager existence. To reduce this further would have created greater poverty, hunger, disease, and political upheaval.

## Tariffs

- After the war, Germany attempted to create a democratic government. Kaiser Wilhelm II had abdicated, and the imperial monarchy was replaced with a parliamentary government. But the German government—known as the Weimar Republic, after the city that served as a temporary German capital—could survive only if it provided for its people.
- To make matters worse, the British and French governments erected tariff barriers and limits on imports from Germany. This made it impossible for the Germans to fulfill their financial obligations.
- When Germany was prevented from earning enough money through exports to pay the reparations, it resorted to the usual tactic of weak governments: It began to print money. The result of this process is inflation. In Germany, it was hyperinflation.
- At the same time, the Germans were also unable to import significant amounts of goods and services from France and Great Britain. So, the French and British economies suffered unemployment and business failures as a result.
- To make the British economy even worse, the British Treasury decided to go back on the gold standard and set the value of the British pound at four pounds to the U.S. dollar. This was an unrealistically high exchange rate, based on the historical value of the pound in the days before World War I, when the British economy led the world.

- ◀ It sounds good to have a highly valued, strong currency, but there are some real costs. Those costs are borne by the export industries of an economy. An expensive currency means that your goods and services are expensive to foreigners. And if this is so, then foreigners will buy less from you. Your sales, profits, and employment in export industries will all decline.
- ◀ The British economy was heavily dependent on exports, so diminished export demand had a significant effect on its entire economy. The British Treasury's decision to set the value of the pound unrealistically high was compounded by the tendency of all countries in the international capitalist system to begin raising tariffs on imported goods.
- ◀ Tariffs are essentially sales taxes on foreign goods. The idea is to make foreign goods more expensive for domestic consumers and to switch demand from foreign goods to domestic goods. This is thought to aid domestic businesses, increasing the demand for domestic products and thus the capacity to increase employment in those protected industries.
- ◀ But once one country raises tariffs on foreign goods, other countries retaliate by imposing tariffs of their own. Thus begins a downward spiral of international trade and macroeconomic activity.

## **Economic Trouble in Europe**

- ◀ During the 1930s, tariffs were at their highest levels in history, and international trade was at its lowest. That is one of the key reasons for a growing recession in Europe at the time.

- ◀ Britain began to suffer a downturn in economic activity by the mid-1920s. And British employers started demanding wage cuts from their workers to protect sales and profits. In response to these demands, Britain suffered a general strike of all major trade unions in 1926.
- ◀ Other important economies in Europe, and around the world, began a process of competitive devaluations. A country might gain a trade advantage if its currency becomes cheaper on foreign exchange markets. But this works only if no other countries pursue the same policy. As in the case of tariff policy, once one country attempts to gain a competitive advantage by depreciating its currency, other countries match it, and the world's foreign exchange system breaks down.
- ◀ Later, during World War II, the United States and several allies created a new multilateral organization—the International Monetary Fund—for the express purpose of providing stability to the world's foreign exchange rate system. Later, the European Union created a single currency, the euro, to accomplish some of the same objectives.
- ◀ Because Germany was required to run large balance-of-payments surpluses, the Germans began to drive down the value of their currency, the mark, by printing more and more money. This was also Germany's last, and futile, attempt to pay its reparation obligations.
- ◀ German hyperinflation during the 1920s haunted the national conscious for generations to come and accounts for a near-paranoid fear of inflation among many present-day German bankers, voters, and politicians. The cure for hyperinflation is cancelling the currency and a severe depression to drive down prices and wages.

- ◀ The depression in Germany at the end of the 1920s and early 1930s fostered the economic and political conditions for the rise of the Nazi Party. The financial turmoil in Germany was also the proximate cause of the start of the European depression in May 1931.
- ◀ The U.S. stock market had already crashed, but there was not yet a financial breakdown in Europe. That happened when a major bank in Vienna, Creditanstalt, collapsed due to its inability to handle depositors' withdrawals. Creditanstalt declared insolvency and thus set off a chain of events that is common in capitalist systems undergoing financial panic: If there's no lender of last resort—usually a national central bank, with the power to lend—commercial banks all fail in a chain reaction because typically they've lent money and deposited it with each other.



International trade and globalization have many benefits for a capitalist system. Globalization provides wider opportunities for investment and profits and delivers a variety of products and resources at cheaper prices. But globalization also increases the probability that crisis in one economy will be transmitted to all other economies.

## Readings

KEYNES, *The Economic Consequences of the Peace*.

SKIDELSKY, *John Maynard Keynes*.

## Questions

- 1 According to the Treaty of Versailles, how would the Germans get the money to pay the British and the French the war reparations they owed?
- 2 Why were the high tariffs adopted by the British and the French in the 1920s ultimately to prove disastrous for the British, French, and German economies?



## *Lecture 10*

# How FDR and Keynes Tried to Save Capitalism

**T**HE GREAT STOCK MARKET CRASH OF 1929 DID NOT cause the Great Depression, but it was one of the events that intensified the contractionary forces of the American economy at the time. The underlying causes of the Great Depression in the United States were created by policies and events earlier in the decade of the 1920s. Some—such as the Treaty of Versailles, which practically guaranteed a depression in Europe—took place outside of the United States. However, most causes of the Great Depression were created in the United States. Some were the result of a largely unregulated macroeconomy, and some resulted from government policies. ♦

## Macroeconomic Principles

- ◀ One hallmark of a market economy is that nobody oversees all economic activity, or the production and consumption decisions of the millions of business firms and consumers. The relatively free decisions of independent people lead the economy in the direction that most consumers and businesses desire, but the uncoordinated actions of individual producers and consumers can also lead to cycles of boom and bust in a capitalist market economy.
- ◀ In macroeconomics—which refers to the analysis of an entire economy—one process at work is a multiplier, an idea pioneered by John Maynard Keynes. It's based on the simple idea that one person's spending is another person's income. If someone spends less, then someone else is making less. As that individual's income falls, spending falls again—and the process continues. So, a decrease of economic activity in one sector has repercussions across the economy.
- ◀ Another important idea in macroeconomics is the so-called fallacy of composition: the error of thinking that what is good, or advantageous, for one individual will also be advantageous for a group. If one farmer increases planting to get more income from the higher prices, that works. But if all farmers increase production, it's possible that all farmers will actually get less income—even from a larger crop.
- ◀ At the beginning of a recession or economic downturn, it's wise for individuals and households to cut back on spending and build up some cash reserves to prepare for the potential bad times. Businesses might cut back on new equipment orders or cancel some expansion plans if they think there will be a decrease in demand for their products.



In the 1920s, farm prices were high, and most farmers enjoyed rising incomes and profits. This encouraged them to plant more crops. Soon, because of the increase in production, there was a glut on the market, and farm prices plunged. That sent many farmers into bankruptcy. As farmers went bankrupt, their suppliers lost income, and some went bankrupt as well. Farm community stores, shops, businesses, and local governments all suffered.

- ◀ However, if the behavior is widespread, the macroeconomy will suffer. Total spending will fall, total incomes will fall, production will fall, and unemployment will rise. Keynes labeled this phenomenon the paradox of thrift: In periods of recession or depression, saving—or being thrifty—actually causes more economic hardship throughout the macroeconomy. This was especially true during the Great Depression.

- During the Depression, the multiplier effects of the paradox of thrift were so strong that the U.S. economy suffered from prolonged and deep deflation—meaning that most prices of goods, services, and wages were decreasing. It might seem like a good thing that prices are falling if you're a consumer, but if you're the producer or seller, declining prices are definitely bad.
- And deflation tends to feed on itself. If you're holding onto money, deflation makes your money worth relatively more. If you think that's going to continue, then you keep holding onto your money. And demand for goods, services, and labor will continue to decrease, leading to further declines in prices.
- The worst thing about deflation is what it does to those in debt. Farmers and businesspeople often must borrow before they receive the proceeds from the sale of their products. If prices fall, their incomes will fall, and their ability to repay debt decreases. This leads to the bankruptcy of farmers and businesses, and maybe even to the failure of the banks and other financial institutions that were the lenders.

## Galbraith's Five Causes of the Great Depression

- In his book *The Great Crash, 1929*, John Kenneth Galbraith listed five principle causes of the Great Depression. For each cause, subsequent policies and institutions were developed to prevent, or at least reduce, the probability of another Great Depression.
  - The first cause was a tremendous inequality of income and wealth. An economy of extremely wealthy and extremely poor people is unstable in a capitalist economy. Those who are wealthy tend to become less aware, or fearful, of risk and

tend to have a more unstable spending pattern. In contrast, poor people have a relatively stable spending pattern. As income becomes concentrated in the hands of the rich, it doesn't have to be spent, causing a decrease in total spending. Household debt rises in low-income families, and any economic downturn—and loss of employment—causes numerous personal and business bankruptcies.

- 2 The second cause was the shaky state of corporate structures. Corporations were largely unregulated in the 1920s and earlier and had little government supervision of their financial information or financial practices. Additionally, a new form of investment vehicle was created, called the investment trust, which was a security created by combining into one basket the shares of stock in many individual corporations. As long as enough people were buying shares of stock, the market kept going up, but as soon as investor sentiment changed and growing numbers of people tried to sell their stock, then there was the potential for a stock market panic—and crash.
- 3 The third cause was the structure of the banking system. Some banks were sound; they made good loans and did not speculate in risky stocks. But banks lend to one another. When a shaky bank fails, it can't repay the good bank, and the good bank can't satisfy all of its depositors' claims either. Prior to the mid-1930s, there was very little regulation and oversight of U.S. banking activities. Although the Federal Reserve Board had been created by Congress in 1913, it was run by bankers and political appointees who tended to adopt the viewpoint of commercial bankers.



Perhaps surprisingly, Black Tuesday was a result of the Great Depression, not the cause of it.

- 4 The fourth cause was concentrated outside of the United States. Although the United States had few exports at the time—and therefore the country was not dependent on sales of U.S. products to foreigners—it had lent large sums of money to European governments after World War I to help rebuild Europe. Then, the United States imposed very high duties on imports under the Smoot-Hawley Tariff Act of 1930. European imports to the United States fell, and European companies and banks began to fail. A bank collapse in one European country spread to other countries, and the Great Depression took hold in Europe before it hit the United States.
- 5 The last major cause of the Great Depression was the profound state of ignorance about macroeconomics.

## Keynesian Economics

- ◀ Prior to the Great Depression, classical economists assumed that a market economy—with flexible prices and competition—would never suffer from a general slump in economic activity. Therefore, the prevailing economic wisdom was to leave the economy alone and wait for it to return to health.
- ◀ Keynes mocked this assumption, which held that after a sufficient period of time, economies would come back to full employment and maximum production. A recession would be temporary, and suffering would be minimal.
- ◀ The Great Depression was not temporary—it persisted. And human suffering was immense. The Depression stimulated the analysis of Keynes and a large group of younger economists to rethink the nature of a capitalist system and its tendencies.

Mass unemployment is a breeding ground for political instability and extremist political parties. Many historians blame the rise of Nazi Germany on the effects of the Great Depression.



- ◀ Keynesian economics is primarily macroeconomics, and the modern study of macroeconomics began with the theories of Keynes and his collaborators. Keynesians are often referred to as activist economists, who believe in active macroeconomic policies by national governments and central banks.
- ◀ In some shape or form, Keynesian fiscal and monetary policies are the dominant economic programs of most major governments and central banks in the world today.

## FDR's New Deal

- ◀ The reform of American capitalism as a result of the Great Depression began with the first administration of Franklin D. Roosevelt in 1933 and the beginnings of the New Deal.
- ◀ The first major policy initiative of the Roosevelt administration was FDR's March 1933 order to temporarily close all banks and decide which were healthy enough to reopen. After this, Roosevelt pressured the Federal Reserve to increase the nation's money supply and to take the United States currency off the gold standard.



- Many economists, especially Milton Friedman, blame the Fed for exacerbating the Depression by cutting the money supply and raising interest rates when the economy began to tighten. Until then, conventional wisdom held that inflation was a serious danger if the money supply increased at all and that a capitalist economy needed sound money above all else to function. But cutting the money supply at the beginning of an economic downturn is the exact opposite of the rational policy.
- To reverse the process of deflation—that is, falling prices—Roosevelt and his more progressive advisors pushed the Federal Reserve and U.S. Treasury to buy bonds and put more money into circulation.
- To improve the banking structure and provide more security for depositors, Congress passed the federal Banking Act of 1933, better known as the Glass-Steagall Act, which separated commercial and investment banking and created the Federal Deposit Insurance Corporation (FDIC).
- Galbraith maintains that the creation of the FDIC did the most to restore stability and confidence to the American banking system. There have been no systemic bank runs in the United States since. American depositors know that their deposits—up to an insured limit—are safe.
- To remedy the bad corporate structure leading up to the Great Depression, the New Deal created the Securities and Exchange Commission, a federal agency responsible for ensuring that publicly traded corporations produce accurate financial information and that stock markets operate in a fair and orderly manner. Its political structure, consisting of five presidentially appointed commissioners—with the party in power always holding a majority—all but ensures that many major decisions are narrow majorities in danger of being reversed next term.



- ◆ To get the economy moving again during the Great Depression, expansionary monetary policy was necessary but would not be sufficient. Fiscal policy, including direct government spending, was also necessary to revive the economy.
- ◆ FDR ordered public works projects at the hands of the Civilian Conservation Corps, which put young people to work in national parks and forests. The federal government also funded the Public Works Administration to reduce unemployment through the construction of highways and public buildings.
- ◆ The New Deal also created the Social Security Act of 1935 to counter the poverty of the American elderly, as well as widows and orphans. The Social Security Act also contained provisions for federally funded unemployment insurance.

- ◀ Social Security created what macroeconomists call automatic stabilizers. When the economy goes into a downturn, there is some level of spending that will not be reduced. So, the downturn is cushioned from falling any further.
- ◀ At the other end of the income spectrum, the federal income tax was also made much more progressive during the New Deal, starting in 1936. A progressive tax is where the tax rate goes up as income levels climb. This contrasts with a flat tax, where the rate remains the same regardless of income.
- ◀ A progressive tax is viewed as another automatic stabilizer, because the tax rate rises on individuals as incomes are rising and inflation becomes a more likely problem. Taking more income and spending out of the economy as inflation occurs will help reduce the demand pressures that create inflation.
- ◀ Conversely, when individual incomes are falling, the progressive tax automatically cuts the tax rate that individuals pay. This is exactly what you want to happen in a recession: that people get a larger share of their total income so that they will have more money to spend out of the income they receive.



In 1944, the top marginal tax rate in the United States was set at 94 percent on incomes over 200,000 dollars, which is about 2.5 million dollars today.

- ◀ The nature of the American capitalist system was profoundly changed by the New Deal. The U.S. capitalist system is much more regulated and managed than it was at the beginning of the 20<sup>th</sup> century, and no responsible political party, or politician, has argued for a complete repeal of New Deal policies.

In the United States, regardless of the political party in power, it has been the role of the federal government (through fiscal policy) and the Federal Reserve (through monetary policy) to stabilize the American economy and prevent a recurrence of the Great Depression.

### Readings

GALBRAITH, *The Great Crash*.

KINDLEBERGER, *Manias, Panics, and Crashes*.

RAUCHWAY, *The Money Makers*.

### Questions

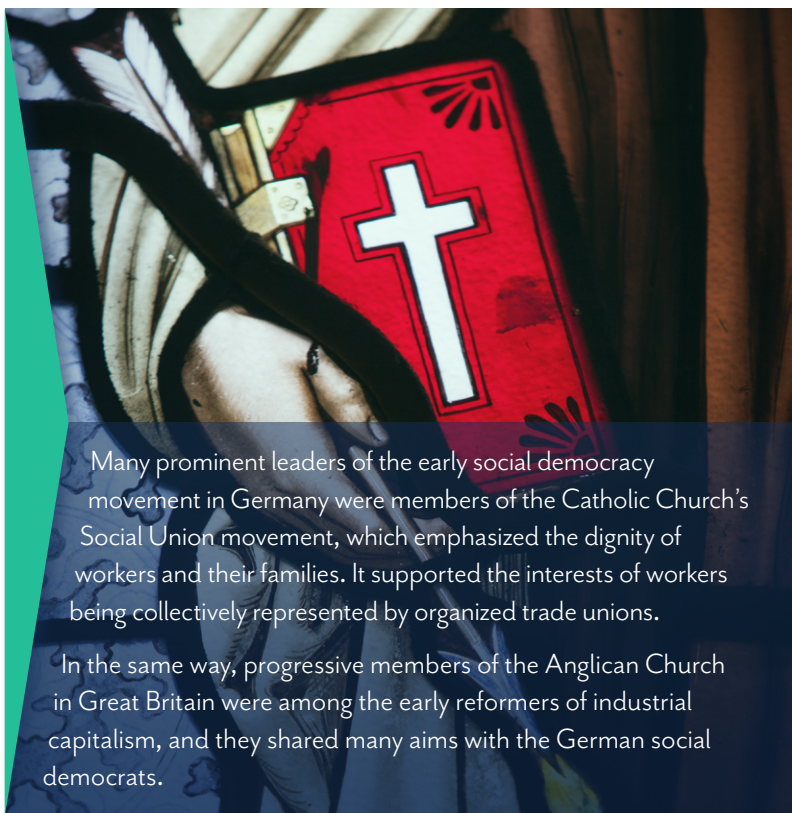
- 1 According to Keynes, when businesses and consumers adopt prudent actions in advance of an expected economic downturn, this proves to be macroeconomically damaging. Why?
- 2 Both Keynes and Friedman placed major blame for the Great Depression in the United States on the Federal Reserve. What was the Fed doing at the beginning of the Great Depression that merited such condemnation?



## *Lecture 11*

# Social Democracy in Europe

**S**OCIAL DEMOCRATS BELIEVED THAT CAPITALISM could be reformed and made to work for the benefit of all members of society and that such improvements could be achieved through democratic elections and reform. Social democrats in all European countries believed that some form of planning, or state management, was essential to reform and sustain the capitalist system. But all European countries that adopted social democratic policies and developed social democratic parties implemented reforms and planning in different ways, so a discussion of European social democracy is not a description of one model of society but an exercise in comparative economic policies and institutions. ♦



Many prominent leaders of the early social democracy movement in Germany were members of the Catholic Church's Social Union movement, which emphasized the dignity of workers and their families. It supported the interests of workers being collectively represented by organized trade unions.

In the same way, progressive members of the Anglican Church in Great Britain were among the early reformers of industrial capitalism, and they shared many aims with the German social democrats.

## Reforming Capitalism

- Some historians distinguish between ethical motives for reforming capitalism and prudential motives. Ethical motives include the belief that allowing poverty and unemployment to exist in society is immoral and contrary to Christian values of charity and love of humankind.

- ◀ Prudential motives, by comparison, are based on the idea that poverty and unemployment lead to social upheaval and class violence. Therefore, to save capitalism from violent opposition, the prudential reformer believes that it's necessary to assure some basic level of well-being for even the lowest members of society.
- ◀ Capitalist development created certain human problems in all capitalist economies. Industrial capitalism in the late 19<sup>th</sup> century led to the explosive growth of cities and large factory production. This growth and industry led to increases in production never seen in human history.
- ◀ Urban growth created by capitalism brought with it problems of pollution, crowding, crime, poverty, and disease. These problems also created ethical and moral dilemmas.

## **The Beginnings of Social Democracy**

- ◀ The beginnings of social democracy and reform movements started with highly educated, upper-class members of Victorian society. One such person was William Beveridge, who became a member of a group of intellectual reformers that also included Sidney and Beatrice Webb, founders of the Fabian Society—a group of democratic socialist thinkers.
- ◀ The Webbs provided some of the ideas that inspired the formation in 1900 of a group known as the Labour Representation Committee. In 1906, it became the British Labour Party.
- ◀ Much later, Beveridge would author a major post-World War II report that brought substantial changes to the British capitalist system. The Beveridge Report was the blueprint for the creation

of the modern British social welfare state. It called for the creation of, among other things, a national health system funded and operated by the British government.

- ▶ But even decades before the Beveridge Report, the Webbs and their fellow democratic socialists advocated a national insurance program that would provide pensions for older people and unemployment insurance for workers who lost their jobs. They were among the first to argue for a system of national health care—provided by the state—for all members of British society.
- ▶ The German social Catholics would also support a social welfare state that included government-funded health care for all families as well as support for labor unions that included all workers.
- ▶ The German trade union movement included not only industrial workers, but also public employees, workers in service industries, and farmers. This reflected the social Catholic value of solidarity and care for all members of society, regardless of their economic status or wealth.

## Public versus Private Goods

- ▶ One frequent criticism of capitalist economies is that capitalism produces an excess of private goods and a shortage of public goods. Many controversies in comparative economic systems involve the definition of just what exactly is a public good and a private good and whether it is necessary for governments to produce public goods.
- ▶ The American economist Paul Samuelson gave the clearest definitions and distinctions between private goods and public goods. He said that private goods can be characterized as

rivalrous and excludable. In this context, rivalrous refers to the idea that if someone consumes any of the good, there is less for you. A pizza is rivalrous. Excludable means that you can be prevented from consuming the good. If you don't have any money, you can't buy a pizza.

- Public goods are nonrivalrous and nonexcludable. One of the most famous examples economists use is a lighthouse on a rocky point in the ocean. If you're in your ship and you see a lighthouse, that doesn't mean that someone else can't see the lighthouse. Your use of the lighthouse doesn't diminish another person's ability to benefit from it. And nobody can be excluded from the benefits of the lighthouse even if they didn't pay anything to get it built.
- One of the problems with public goods is called the free rider problem. This problem is why public television must have so many pledge drives. Once it broadcasts, anyone can receive and enjoy the same show. Alternatively, we "pay" for most commercial television by having to put up with all the inane and intrusive commercials.
- Television is a public good in the Paul Samuelson sense. Other important public goods are clean air, clean water, public health research, and programs to eliminate communicable diseases.
- The questions of what public goods should be produced, how much should be produced, and how they should be paid for were important questions for early proponents of social democracy.
- Capitalism proved quite spectacular at producing private goods. But in its early days, capitalism was not so good at producing public goods.

## The Rise of Social Democracy

- ◀ In Britain, the Labour Party began to advocate for the national government to provide public goods early last century. The origins of the National Health Service and municipal water systems are found in the early struggles against communicable diseases, such as cholera and tuberculosis.
- ◀ The Labour Party won its first parliamentary majority in 1924 on a platform of reforms and public-sector responses to what it portrayed as the more egregious effects of capitalism. And while the Labour Party initially advocated the replacement of capitalism with a socialist economy, it was to be achieved peacefully through the ballot box.
- ◀ In Germany, the beginnings of social democracy—and the reform of the capitalist system—took place somewhat earlier, under the government of 19<sup>th</sup>-century chancellor Otto von Bismarck, who created the first system of public health care and unemployment insurance in a capitalist economy. He was responding to pressures from communist, social democratic, and workers' organizations.

Otto von Bismarck was the founder and first chancellor of the German Empire, from 1871 to 1890.



- ◀ The rise of social democracy in Germany has an echo in the United States, in the rise of the Socialist Party of Wisconsin—especially in the city of Milwaukee, which at one time had a very large German immigrant population. The Socialist Party of Wisconsin was a reforming party, not a revolutionary one. It concentrated on municipal improvements in streets and the water and sewer systems. Socialists in Milwaukee ran successful political campaigns until the end of the 1950s.
- ◀ The ethical or moral basis for the rise of social democracy comes from Judeo-Christian theology concerning charity and the welfare of fellow humans. In this view, the suffering of humans, whatever its cause, requires us to try to alleviate that suffering. To some religious thinkers, permitting the continuation of suffering among one's fellow human souls could be considered immoral and sinful.



The Social Democratic Party of Germany was founded in 1863, and by 1912, it was the largest party in the German parliament, or Reichstag.

- ◀ Sometimes that alleviation of suffering can take the form of private charity and individual good works. But in the rapidly developing capitalist system, private acts of charity came to seem insufficient or incapable of dealing with the human consequences of industrial capitalism.
- ◀ The prudential reasons for social democracy come from fear. Increased numbers of working-class laborers were often underpaid, injured, poorly housed, and poorly fed at the end of the 19<sup>th</sup> century. This led to the rise of trade unions and labor-based political parties.
- ◀ These working-class organizations could potentially be violent and revolutionary. Revolutionary communist parties—along with socialist and social democratic parties—all attracted working-class support. Socialist and social democratic parties generally favored nonviolent and electoral means to achieve their goals.
- ◀ In contrast, communist parties often had no reservations about using violent means to achieve the complete overthrow of the capitalist economic system. If revolutionary communist parties garnered enough support, private property and capitalist profits would be jeopardized. In such an uncertain situation, business confidence, investment, and economic growth would deteriorate.
- ◀ Some thought it prudent—or moral—to create a system of public unemployment benefits, health care, housing, and pensions to pacify the radicalizing working class. Workers who were upset with their working and living conditions could join or support fascist, as well as socialist or communist, parties.
- ◀ Even today, one of the fears of unemployment in Europe is that it furthers the growth of fascist parties, such as the National Front in France and the Golden Dawn in Greece.

## Unstable Capitalism and Stabilizing Influences

- ◀ A final reason for social democracy's attempts to reform capitalism is the belief among many economists and political leaders that the capitalist system is inherently unstable. Not only John Maynard Keynes in Britain but also economists in Sweden, Germany, France, and Austria developed theories about the tendency of capitalist economies to go through phases of booms and busts.
- ◀ It was thought that capitalism was bad for ordinary workers and citizens, as well as those who generally controlled the means of production. Capitalism would generate periodic bouts of unemployment, poverty, hunger, and homelessness.
- ◀ Modern capitalist enterprise—which is usually large enterprise—requires comprehensive long-run planning. Capitalist managers and their bankers need some reasonable forecast of sales to make rational financial and production plans. If the economy is radically unstable, such planning is impossible.
- ◀ The capitalists might be against government or public planning, but they could not survive without planning for their own individual enterprises. Even large capitalist enterprises must react to economy-wide, or macroeconomic, conditions.
- ◀ So, if overall business activity in the economy is diminishing, then individual capitalist enterprise managers must cut back on their production plans and purchases. Such cutbacks on purchases have a ripple effect that tends to exacerbate swings in economic activity.

- ◀ Somewhere, there must be a stabilizer. And the stabilizer cannot be governed by private-profit considerations. By process of elimination, that leaves only national governments to fulfill the role of stabilizer. You could say that the stabilizer function is a very important public good.
- ◀ Unemployment insurance and old-age pensions provide another important stabilizing mechanism. When workers lose jobs, they lose income and spending power. This is obviously bad for the workers, but it's also bad for all the merchants, landlords, and financial institutions where these workers were customers. By providing unemployment insurance—which pays a temporary cash benefit—workers retain some spending power and are able to support the businesses that depend on them. Old-age pensions do a similar thing on a more permanent basis.
- ◀ Central banks are another stabilizing influence on capitalist economies that are created by national governments. In the United States, the Federal Reserve System was created by an act of Congress in 1913 in response to the financial panic of 1907. The Federal Reserve System didn't function effectively at first and made some mistakes during the Great Depression, but it has functioned well for many decades.
- ◀ Even so, the reforms and new public programs of the Progressive era, from the 1890s to the 1920s, didn't prevent the Great Depression of the 1930s. These public-spending and pension programs were small at first and not well funded. There was a continuing belief by many politicians and economists in the need to maintain a balanced public budget each year, in good times and bad.

- ◀ The adoption of a more elastic approach—most significantly in the form of Keynesian deficit-spending policies in times of economic downturns—would have to wait until after World War II. The significantly larger taxes needed to pay for these massive public-spending programs would also not come about until World War II.
- ◀ Progressive income taxes would provide the national income for governments to undertake historically unprecedented levels of public spending to support public works, unemployment insurance, public health policies, and old-age pensions.



Early social democrats would be astounded—and probably pleased—that many of the reforms and programs they advocated in the late 19<sup>th</sup> and early 20<sup>th</sup> centuries are widely in place today.

But all such benefits have a cost. The generous social programs in Europe mean that Europeans pay the highest tax rates in the world.

## Readings

BARZINI, *The Europeans*.

CRAIG, *The Germans*.

## Questions

- 1 The social democracy movements in both Britain and Germany had significant religious roots. What religious values inspired these movements?
- 2 What economists call public goods often have to be paid for with mandatory taxes on all citizens. Why is this government intervention in a market economy sometimes necessary?



## Lecture 12

# Sweden's Mixed Economy Model

**S**WEDEN IS THE BEST EXAMPLE OF AN ECONOMIC system in between the extremes of free market capitalism and government-owned and controlled socialism. The modern image of Sweden is of an egalitarian economy with a high standard of living, a high level of social welfare spending—and a correspondingly high level of taxes. In this lecture, you will discover how the Swedish economic system evolved into the mixed economy it has today. ♦

### A History of Equality



- ♦ One of the enduring values of Swedish society is a national sense of solidarity and equality. This has deep roots in Swedish history. Solidarity was created, in part, by the harsh and variable climate and by the early abolition of feudalism.



- ◆ Sweden was one of the first European countries to create a society of independent farmers who owned their own land. This created incentives to produce as much as possible. But production was limited by the northern climate and its short growing season. The unfavorable conditions meant that Swedish farmers were compelled to rely on one another and share in the burdens and risks of farming.
- ◆ One of the primary forms of economic organization that Sweden created, and is still alive today, is the cooperative. Cooperatives share expenses, expertise, risks, and rewards of economic activity. By their very nature, they tend to even out the vagaries of the larger market. This promotes a rather egalitarian outcome in terms of income distribution.
- ◆ The abolition of feudalism—serfdom and slavery were outlawed in 1335—also eliminated one of the major class divisions in society and limited how unequal income and wealth could become. Countries that have much longer histories of feudalism, such as France and Spain, tend to have much more hierarchical social structures and much more unequal distributions of income.



One of the incorrect stereotypes about Sweden is that it is a socialist system, with predominantly government ownership of the means of production. On the contrary, Sweden is a mostly privately owned economic system with limited direct government ownership of productive enterprises. But the modern Swedish government is heavily involved in the country's economic system.

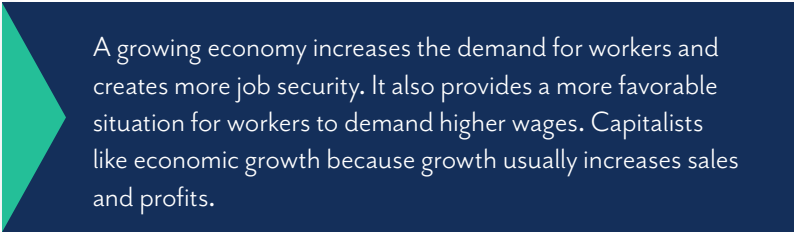
## Trade and Exports

- ◀ Sweden is a large country geographically but quite small in terms of population. To be economically viable, Sweden has always had to rely on foreign trade for markets for its goods—and for vital imports unavailable domestically.
- ◀ In the 16<sup>th</sup> and 17<sup>th</sup> centuries, Sweden was one of the members of the Hanseatic League, an international organization of trading partners in the North Sea and the Baltic Sea that facilitated trade and provided a secure legal framework for trading enterprises and shippers.

- ◀ Sweden was primarily an exporter of wood and wood products in the Hanseatic League. Later, in the 19<sup>th</sup> century—as technology developed—Sweden became an exporter of metallurgical and engineering products.
- ◀ But the technological improvements to Swedish industry, and the growth of large-scale commercial forestry enterprises, created large factories in major Swedish cities and migration from the countryside by displaced farmers.
- ◀ The familiar result was excess labor supply in the cities and cycles of unemployment and poverty. Severe poverty in the late 19<sup>th</sup> century led to the migration of more than a million Swedes to America in search of economic opportunity. The Swedish workers who remained also began to form cooperatives for basic consumer goods and trade unions to bargain for better wages and working conditions.
- ◀ In World War I, Sweden was a neutral country and benefited from the demand for war goods. This foreign demand gave a boost to Swedish industry for a few years, but the end of the war brought a severe recession to the Swedish economy.
- ◀ Because of the postwar recession, Swedish workers began to organize and strike for higher wages and more secure working conditions. Swedish industrialists resisted the workers' demands. There were violent confrontations between the workers and the security forces of the industrialists.
- ◀ This left a deep impression on the Swedish people and a continuing fear of social collapse and anarchy. Ever since, the memory has contributed to relatively mild labor-management relations in contemporary Sweden. There's still conflict between workers and industrialists, but the conflict is carried out mainly in the political sphere.

- ◀ After Swedish workers organized into industrial trade unions, they created a political party based on the trade union movement—a practice common in other European countries, too. The trade union federation in Sweden is the LO, which stands for *Landsorganisationen*, or national organization. The political party created from this organization is the Swedish Social Democratic Party.
- ◀ Because Sweden is a rather small economy and modern factories are large enterprises, it was relatively easy to organize Swedish workers. Even in a small economy, factories need to be large to take advantage of economies of scale—the effect of reducing per-unit costs as the scale of output increases—to be internationally competitive.
- ◀ The Swedish Social Democratic Party won the office of prime minister for the first time in 1920, and—with one brief interruption—has governed Sweden ever since.
- ◀ Sweden has a parliamentary system with proportional voting, which means that there are many parties in the Swedish political system. There are farmers' parties, small business and professionals' parties, employer-based parties, and green parties. Such a system rewards the largest party, even if it's not a majority party.
- ◀ In most parliamentary systems, there's rarely a majority party. Typically, coalitions must be formed with two or more parties that can achieve a majority of votes. A government will then be formed, with the largest party choosing the head of government—usually called the prime minister or chancellor.

- ◀ Sweden has a prime minister, and this person has typically been a member of the Swedish Social Democratic Party. This dominance of the Swedish government by a workers' party makes it easier to understand the major objectives of most Swedish governments. They are the objectives of the workers organized in trade unions.
- ◀ These objectives are not always in conflict with the interests of Swedish capitalists and business leaders, although they often are. The objectives that are shared between workers and capitalists tend to be concerned with foreign trade and the necessity for Swedish exports to be competitive on the world market. This means that Swedish workers' wage demands can't be too outrageous, or Swedish goods will be too expensive for importing countries.
- ◀ Swedish goods must also be of high quality and reliability. This means that they must be well made and attractive. Workers, therefore, need to be concerned with the quality of their work and the quality of the products they produce.
- ◀ Swedish companies that are heavily dependent on exports—and almost all Swedish companies are dependent on exports—must also be very concerned with the quality and marketability of their products.



A growing economy increases the demand for workers and creates more job security. It also provides a more favorable situation for workers to demand higher wages. Capitalists like economic growth because growth usually increases sales and profits.

## Key Fiscal Policies

- ◀ In the Great Depression of the late 1920s and early 1930s, the Swedish government was one of the first to use active fiscal policy to counteract the effects of the depression. On a limited basis, the Swedish government initiated public works projects and increased transfer payments to pump up demand for Swedish goods and services. They were practicing Keynesian policies before Keynes had developed his theories of how to get a capitalist economy out of a depression.
- ◀ World War II provided another boost to the Swedish economy. Sweden was a neutral country once more and did not suffer any damage to its domestic economy. And the war once again stimulated the economy. After the war, the Swedish economy faced a problem of declining demand for war goods and the resulting decline in sales and employment. But this time, Swedish firms were able to transform their production to peacetime output.



Because it was a neutral country in both world wars, many people assume that Sweden is pacifist, with no military-industrial complex in its economy. On the contrary, Sweden is a significant producer and exporter of high-technology military hardware.

- ◀ The best example is the Swedish Aircraft Company, or *Svenska Aeroplan Aktiebolaget* (SAAB). In World War II, SAAB did a booming business in military aircraft. But after the war, demand for its products decreased significantly. So, with its very sophisticated industrial plants and highly skilled engineers and workers, SAAB decided to make cars. For 60 years, SAAB was an important car company, but it has since gone bankrupt.
- ◀ After World War II, the Social Democratic-led governments initiated several key policies to establish the Swedish economic system as a mixed economy. Because the Swedish Social Democratic Party was founded and supported by the Trade Union Federation, its most important objective was a high rate of employment. So, the government was an active user of traditional Keynesian fiscal and monetary policies to stimulate economic growth and low rates of unemployment.
- ◀ But to achieve high levels of employment, the Swedish governments went far beyond standard Keynesian demand management. The Swedish government pursued active labor market policies. These policies were designed to stimulate and support employment, especially when private market demand might be diminishing. Labor market policies included providing government subsidies to private employers to retain workers that might have otherwise been let go.
- ◀ Because Swedish workers and employers were so well organized, a feature of the Swedish labor market was consensus bargaining and comprehensive labor agreements on wages and working conditions—that every worker gets and thinks is fair. This was especially important due to the dependence of the Swedish economy on exports.

- ◀ One of the primary findings of labor market research in the realm of efficiency wage theory is that workers will work effectively, and well, if they think they're being treated fairly. Swedish workers are paid well, so it's essential that they should also be very productive, if their products are to remain competitive on the world market.
- ◀ Another key policy tool of all Swedish governments is the guidance of the exchange rate—making sure that the Swedish krona is not too expensive in relation to its trading partners. It might seem good to have a “strong” currency that is highly valued and very expensive, but if you are an exporting country, an expensive currency means expensive products. A high value for the Swedish krona means fewer exports of jet fighters, for example.
- ◀ For this reason, although Sweden is a member state of the European Union, it has not adopted the euro. Instead, it has kept its own currency to have another lever with which to manage the flows of exports from Swedish industries.
- ◀ The most controversial aspect of Swedish government policy is the country's extensive welfare state and income redistribution. Swedish citizens receive free health care, free education through university, high levels of unemployment benefits and pensions, and generous family leave for parents of newborns. The Swedish government also redistributes income in a more comprehensive way than any other government in the world.
- ◀ One cost of Sweden's well-developed social structure is the tax burden on the average Swedish worker. Swedes pay an average of 53 percent of their income in taxes. Sweden ranks 5<sup>th</sup> in the high-tax category; only Finland, Denmark, France, and Belgium rank ahead of Sweden.

- High taxes can legitimately be said to limit freedom. The Swedish government limits the freedom of Swedish citizens to spend their own money.
- Many Swedish employers and industrialists complain that the country's high levels of economic security and guaranteed income have diminished the work ethic of the Swedish worker—and are a drag on efforts to increase productivity in the face of globalization and foreign competition.
- However, the Swedes have decided democratically to give up some of their individual economic freedom to live in a more egalitarian and economically secure society. Swedish elections are fought over the size and comprehensiveness of their welfare state.

### Readings

OXFAM AND DEVELOPMENT FINANCE INTERNATIONAL,

*The Commitment to Reducing Inequality Index.*

RYNER, *Capitalist Restructuring, Globalization, and the Third Way.*

### Questions

- 1 What was it about Swedish history and geography that created the strong incentives for cooperative agriculture? Where do you find traces of this in the United States?
- 2 Does the Swedish government own a lot of the productive enterprises in Sweden? Why do critics refer to the Swedish economy as socialist?



## *Lecture 13*

# French Indicative Planning and Jean Monnet

**T**HE FRENCH ECONOMIC SYSTEM TODAY REFLECTS A history of wars, revolutions, and political battles between right- and left-wing political parties and is a blend of capitalist private property in industry and agriculture along with significant state ownership and control. The French system of economic planning—led by the state—is known as indicative planning. The word “indicative” distinguishes it from the type of planning used in communist economies, which is referred to as command planning. ♦



The terms “right wing” and “left wing” are French creations.

In the days just before the French Revolution of 1788 and 1799, two factions emerged with very different political positions. Those in favor of retaining the monarchy and a conservative social system sat in the right wing of the conference room, where discussions about the fate of France and the monarchy were being held. Those advocating abolition of the monarchy sat in the left wing of the room.

French economic and political thinking—and actions—have alternated between right and left ever since.

## French Economy and Society

- Control and influence of the economy by the French government has a long history. Even in the time of the monarchy, the French state used taxes and control of foreign trade to lead economic development in the desired direction.
- Protection of French farmers from foreign competition was accomplished with high tariffs on imports of foreign agricultural products. As with all economic policies, this created benefits and costs—winners and losers.
- The winners were the French farmers, who enjoyed relatively high prices and higher incomes. The losers were the urban French workers and, indirectly, French capitalists, who had to pay higher wages to compensate their workers for higher food prices. The redistribution of incomes from workers and capitalists hindered the development of French industrial capitalism and maintained the small scale of the typical French farm.
- The lack of a dynamic industrial sector in France meant that it was a country of small, inefficient farms—and small-scale industry and manufacturing—for most of the 19<sup>th</sup> century. So, while Britain experienced the industrial revolution, France remained a bucolic and peasant country, outside of a few big cities, which were predominantly centers of government, education, and culture rather than of industry and large-scale manufacturing.
- French society suffered many conflicts and upheavals. After the French Revolution—and the abolition of the monarchy—came the Reign of Terror, the guillotine, and the dictatorship of Napoleon Bonaparte. Napoleon did bring some modernizing

changes to the French economy. He created a professional military, a university system for training civil servants and administrators, and a modern legal code: the Napoleonic Code.

- Although France came late to industrial capitalism, French social thought led the way to the creation of socialist theories. Karl Marx credited writers such as Pierre Proudhon—author of the phrase “property is theft”—and Charles Fourier, creator of the idea of syndicalism, as inspirations for his theories of communism.
- The French Socialist Party achieved its first electoral victory in 1936. Coming at the height of the Great Depression, the government of Socialist Party leader Léon Blum advocated higher minimum wages, limitations on the work week, and nationalization of the railroads. However, the German Nazi army’s invasion and occupation of France put an end to the reforms and policies of the Blum government.

In the United States, attorneys in Louisiana must still navigate a legal system heavily influenced by French colonial administrators of the 19<sup>th</sup> century.



- ◀ While the Nazis installed their own government in Paris and directly ruled the northern part of the country, a collaborationist government headquartered in the south carried out Nazi policies in the rest of France. These policies included abolition of trade unions and the suppression of workers' rights and wages, as well as rounding up Jews to be transported to Nazi labor and death camps. This history of French right-wing collaboration—to the benefit of many French capitalists—severely damaged the reputation of conservatives and industrialists in France.
- ◀ One of the main opposition forces in France during the Nazi occupation was the French Communist Party, which provided many leaders to the French Resistance. Socialist Party members also performed heroically in opposition to the policies of the Third Reich. This history of resistance created significant status and support for left-wing parties in French politics after World War II.
- ◀ The communist and socialist parties in France were either outright hostile to capitalism or in favor of significant reform and limits to capitalist economic institutions. To this day, the word “socialism”—and the role of the French Socialist Party—are still key elements of French society and politics.

## Monnet's Indicative Planning

- ◀ The French career military officer Charles de Gaulle—a veteran of World War I and a former German prisoner of war—emerged as a hero of the French government in exile. He led French Resistance forces, who helped the Allies liberate France.

- ◀ De Gaulle was not a socialist or a communist. Rather, he was a French nationalist who wanted to restore France as a leading power in Europe. He also sought, somewhat unrealistically, to make France a leading power in the world again. In 1945, France was a defeated and demoralized country with a weak economy.
- ◀ As a politician, de Gaulle was by no means of the left-wing persuasion, but he became convinced that to redevelop the French economic system, a comprehensive approach was necessary—to include economic planning and significant government involvement.
- ◀ The man de Gaulle relied on was a native of Cognac named Jean Monnet, who never formally held a government position but served as a personal advisor to de Gaulle and to the French Ministry of Planning. Monnet never joined a political party, but he worked for the good of France and the world economy.
- ◀ His two greatest sources of support in the development of his planning initiative were the U.S. government and the French Socialist Party. To prevent World War III—and to help all of Europe rebuild after World War II—the United States created the 12-billion-dollar European Recovery Program. Also known as the Marshall Plan, it was named for George C. Marshall, the wartime U.S. Army chief of staff who would go on to become secretary of state.
- ◀ In France, Monnet used the funds available to his government to develop French infrastructure and industrial capability. One aim of the Marshall Plan was to aid in the development of market-oriented economies and diminish the appeal of communism.



The Marshall Plan was a creation of the Truman presidency. But Harry Truman was politically wise enough not to label it the “Truman Plan.” The plan faced strong opposition from the Republicans in Congress, and Truman needed some Republican votes to get it passed.

- ◀ The Great Depression had been a tremendous blow to the reputation of capitalist economic systems. And the victory of the Soviet Union over the Third Reich created some sympathy and admiration for the Soviet economic system. Communist parties in western Europe—especially in France and Italy—acquired some of this appeal.
- ◀ The French Socialist Party was in favor of reforming the capitalist system and, maybe at some time in the future, replacing it. But the party would replace it only through democratic elections and the will of the majority of the population. Communist parties, in contrast, favored violent revolution and the immediate overthrow of the capitalist system.

- ◀ The French Socialist Party worked hard to distinguish itself from the French Communist Party. And it was more willing to work with Jean Monnet and his plan to make the French economic system modern and productive.
- ◀ The system that Jean Monnet introduced was indicative planning, which means that the government creates plans for major French industries in consultation with domestic business, labor, and government officials. The plans are not mandatory, and there's no overt coercion to fulfill the plan's objectives. The plan merely "indicates" the intentions of the French national government to modernize and develop the economy.
- ◀ However, the French government has many methods with which to realize its plans. And the French government, in contrast with some other European economies with socialist parties in leadership positions after World War II, carried out a significant program of nationalization, which involves government takeovers of privately owned enterprises.
- ◀ The French government nationalized key infrastructure enterprises—including the French telephone, water distribution, and national railway systems—to assure adequate energy and transportation for all French businesses. Additionally, the French government nationalized the banking system to give it control over the distribution of credit and loans to French business and consumers.
- ◀ In recent decades, a prevailing trend in world economies has been to privatize enterprises. But the French continue to maintain an economic system with a significant number of government-owned industries. For example, while British rail has been privatized, the French rail system is still government owned and operated.

- ◀ Added to the direct control the French government exercised over French industrial enterprises, it also used many indirect methods. Industries that were part of the government plan's broader objectives would be offered low-interest loans and easy credit conditions by government-owned financial institutions.
- ◀ Taxes and subsidies were also used to direct business activity. To create incentives for French private business to follow the government's economic plan, differential tax rates—and even direct payments to businesses that were part of the objectives—were also used.
- ◀ These direct and indirect methods gave the French government strong control over the French economic system.

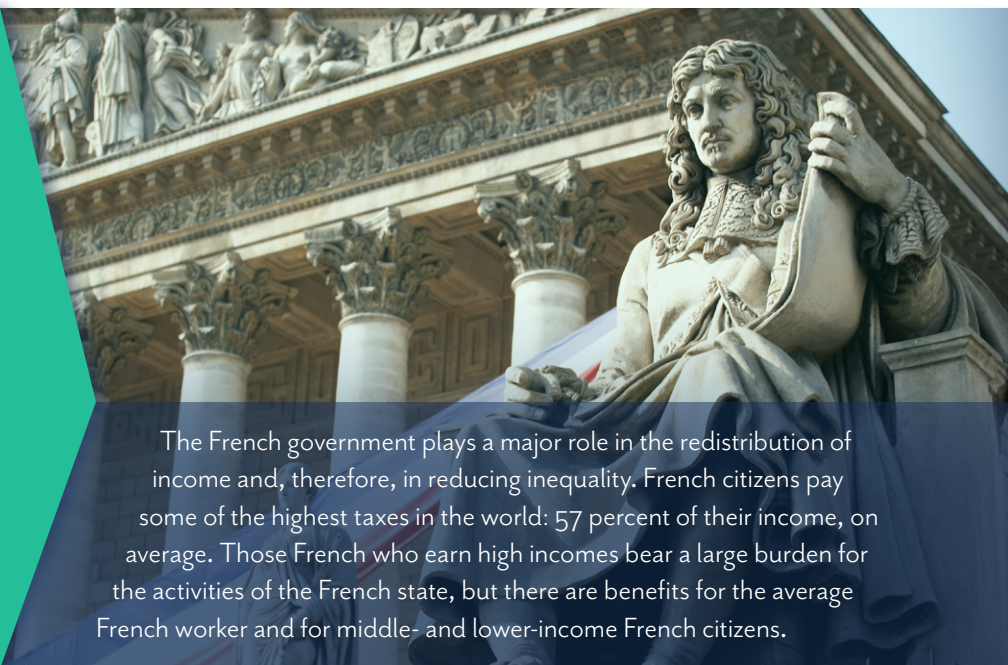
## French Politics and Values

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- ◀ The French, like most electorates, switch back and forth from conservative to left-wing politics and values. Socialist-led governments alternate with more conservative governments. At times, France has been led by political parties influenced by the legacy of Charles de Gaulle. These parties tend to be more conservative. They often favor less government planning and ownership.
- ◀ When Ronald Reagan and Margaret Thatcher's philosophy of free market capitalism was first capturing American and British elections, it briefly also had some influence in France. Some banks were privatized, and major industrial firms were at least partially privatized.

- ◀ But in 1981, France elected the French Socialist Party leader François Mitterrand as president. Mitterrand was elected during a European recession and a big rise in French unemployment, and his original platform was a very left-wing one. It included such elements as the elimination of capital punishment and large increases in the minimum wage and unemployment benefits, paid for with tax increases on the rich. The government also renationalized some of the major banks and public utilities and carried out large construction projects.
- ◀ The Mitterrand program led to big decreases in French unemployment and generated economic growth. However, it also created large government deficits and large balance-of-payments deficits.
- ◀ Unfortunately, while the Mitterrand government was carrying out its expansionary fiscal and monetary policies, the British government, under Margaret Thatcher, and the German government, under Helmut Kohl, were carrying out austerity policies. They were reducing government spending and increasing interest rates.
- ◀ This meant that the French—who temporarily had more income—were importing more British and German products, while the British and the Germans—who temporarily had less income, under their austerity programs—were importing fewer French products.
- ◀ The Bank of France had to raise its interest rate to counteract the higher German interest rates and protect the value of the French franc. This eventually had a depressing effect on the French economy. A decrease in French exports to its two main trading partners also led to layoffs in French exporting enterprises. French voters blamed the Mitterrand government for these unfavorable economic outcomes.

- ◀ Mitterrand's leftist government was followed by the more conservative government of the Gaullist party leader Jacques Chirac. But a French conservative is still in favor of more government direction and social welfare policies by comparison with a conservative in the United States. No French president would radically change the national health-care system, which the World Health Organization has called the best in the world.
- ◀ After 17 years of moderate right-of-center governments under Chirac and Nicolas Sarkozy, the French elected another socialist in 2012: François Hollande. The Socialist Party manifesto, or platform, promised many things, including an increase in the minimum wage, an increase in the research budget, and the construction of 120,000 new housing units a year for the poor.



The French government plays a major role in the redistribution of income and, therefore, in reducing inequality. French citizens pay some of the highest taxes in the world: 57 percent of their income, on average. Those French who earn high incomes bear a large burden for the activities of the French state, but there are benefits for the average French worker and for middle- and lower-income French citizens.

## Readings

DUCHENE, *Jean Monnet*.

JUDT, *Postwar*.

## Questions

- 1 The French seem to like bureaucracy and complex organizations. How does this preference manifest itself in their economic system?
- 2 The French high-speed train network, featuring the TGVs, could be an example of the superiority of public ownership and control. Why might this be?



## *Lecture 14*

# British Labour Party and National Health

**F**OR DECADES, THE ECONOMY OF GREAT BRITAIN HAS alternated between periods of nationalization and of privatization. This coincided with the political battles unfolding at the same time between the left-wing British Labour Party and the right-of-center British Conservative Party. The British Labour Party was founded in 1900 as part of the reform-minded social democratic movement that swept much of Europe and parts of the United States. The Labour Party occasionally carried parliamentary majorities before World War II, but the party's real power to change the system emerged in the aftermath of World War II. ♦

## The Labour Party and the Beveridge Report

- ▶ Prime Minister Winston Churchill's wartime government had been an all-party coalition that successfully led Britain during the fight against Nazi Germany. Churchill followed the inept, and failed, Conservative Party government of Neville Chamberlain.
- ▶ It was Chamberlain who signed the Munich Agreement with Adolf Hitler that ceded Czechoslovakia to the Third Reich. This betrayal colored British opinion of Conservative parliamentarians and gave the Labour Party a significant political advantage in the postwar period.
- ▶ Additionally, Britain's experience of fighting a successful war—and making all the sacrifices necessary for victory—instilled in the average citizen a sense of entitlement at war's end. No more big sacrifices by the average working-class family for the good of the empire and the king.
- ▶ Still, in a rather ironic development right after the war's end, the government of Prime Minister Winston Churchill was replaced by a Labour Party government led by Clement Attlee. The Labour Party was the beneficiary of renewed working-class political demand and power, and the party's victory would usher in profound and far-reaching changes to the British economy.
- ▶ But first, the Potsdam Conference to decide the postwar settlement of Germany convened on July 17, 1945, just outside of Berlin. Josef Stalin, the leader of the Soviet Union, was met by two new national leaders: Great Britain's Attlee and U.S. President Harry Truman.

- ◀ While Clement Attlee was the official head of government, the leading figure in the transformation of the British economic system was William Beveridge. As World War II turned in the Allies' favor, Beveridge was asked to form a commission to propose social policies for Britain after the war. He produced a study called "Social Insurance and Allied Services," commonly known as the Beveridge Report.
- ◀ The Beveridge Report was a blueprint for a Labour Party program of social welfare policies proposed and passed in 1948. It called for comprehensive unemployment insurance, old-age pensions, and—most dramatically—free, universal, public health care.

## **The National Health Service**

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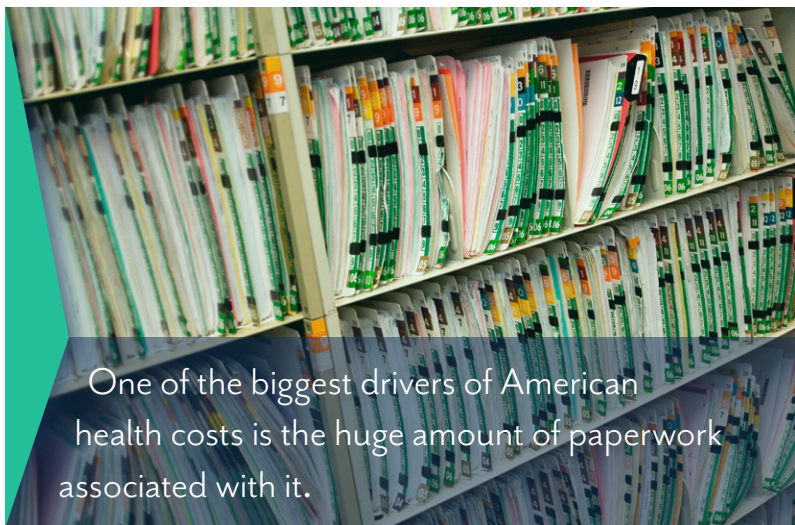
- ◀ The British National Health Service (NHS) would be universal in that all residents of the United Kingdom would be covered. It would be free in the sense that there would be no payments for services or medical bills after treatment. And it would be public in the sense that all hospitals and medical specialists would be employees of the government.
- ◀ Naturally, this raised strenuous objections from doctors organized by the British Medical Association. One of the tactics that the Labour government employed was to allow general practitioners to remain private professionals, who would be paid by the NHS.
- ◀ Like any complex economic institution—especially one that contains principles of socialism or public ownership—there were both costs and benefits to the creation of the NHS.

- ◀ About 47 percent of British income is paid to the government, and sales taxes on all goods and services in Britain average about 20 percent. The British also pay higher income taxes than income earners in the United States. Another cost is measured in the waiting times for nonemergency treatments and the NHS's refusal to pay for some procedures.
- ◀ Because the NHS covers all United Kingdom residents and charges nothing at the point of service, it must implement many cost-reducing policies. One of the most effective is called the capitation payment system.



All systems ration health care. In the United States, it could be the Medicare program, the Veterans Affairs hospitals, or—for most Americans—private insurance. In the United States, about 18 percent of the total gross domestic product is tied up in health care. No other country dedicates nearly as much of its total income to health care. The British spend about half of that, at 9.4 percent. And even so, the British live slightly longer than Americans, at 80.4 years compared to 78.9 years.

- ◀ Although British general practitioners are private professionals, most receive almost all of their income from the NHS. They are paid for each person that registers with their office. And it's a set amount, no matter what kind of treatments or procedures the person receives. The healthier the person, the less expense for the general practitioner and the greater the physician's net income.
- ◀ General practitioners do basic services, such as flu shots—which are free. An enormous public benefit to having everyone in a society covered by flu vaccines is that because less work time is lost, there's more time left over for production of goods and services. There's also a tremendous cost savings due to minimizing doctors' bills, insurance forms, and insurance claims processing.
- ◀ Another component of the British social welfare system that reduces medical costs is the low tuition at British medical schools. British physicians don't graduate with the tremendous



One of the biggest drivers of American health costs is the huge amount of paperwork associated with it.

debt burdens common to American medical students, which push many into medical specialties that promise high incomes, such as plastic surgery and cardiac surgery. British specialists are government employees and live on a fixed salary.

- ▶ British general practitioners are private practitioners who earn more as they accept more clients, so Britain has twice as many general practitioners per capita as in the United States. And most health-care economists conclude that general practitioners who treat symptoms early are a much more effective method of health-care cost control.
- ▶ The most controversial aspect of the NHS goes by the acronym NICE—the National Institute for Health and Care Excellence—which is the gatekeeper for medical practices and procedures in the NHS system. NICE refuses to fund procedures and tests that it deems unnecessary or too costly for the benefits derived. But NICE does play a role in reducing the prevalence and costs of malpractice claims.
- ▶ While the Beveridge plan to create the NHS initially was met with skepticism in the medical community, employers were generally supportive for self-interested reasons. British industry had to compete with other high-income countries on quality as well as price. As the medical expense of providing health insurance was shifted to the national government, employers benefited financially while employing healthier, more productive workers.
- ▶ Business leaders also expressed little objection to the parts of the Beveridge Report that called for universal unemployment insurance and old-age pensions. This arose from the realization that minimum levels of personal income would support consumer demand for goods and services and act as a stabilizer, even amid economic downturns.

- ◀ The Labour governments also introduced a more progressive income tax to redistribute income from the rich to the poor. While income redistribution served to benefit the working-class base of the Labour Party, moving income from the rich to the poor also increases total spending, because lower-income individuals tend to spend a higher percentage of their incomes than higher earners do. Keynes referred to this as a higher marginal propensity to consume. He maintained that differential incomes—income inequality—explains most differences in the tendency to spend.

## Industry Nationalizations

- ◀ The Labour Party initiated a wave of industry nationalizations in the early post-World War II era. At Labour Party urging, the British government nationalized the railroads, coal mines, steel mills, shipyards, electric utilities, and airlines.
- ◀ The goal was to promote employment, high wages, and stable economic activity. The stability argument arose from the Labour Party's belief that unbridled competition among major industrial firms was a key source of prewar economic instability, leading to recessions and the Great Depression.
- ◀ The British were much less interested in economic planning than the French were, with their system of indicative planning. The French government, in consultation with business and labor interests, created a unified economic plan for the country and signaled, or indicated, its preferences through a series of policy prescriptions, including tax incentives and subsidies.

- ◀ The British maintained greater faith in competition and in market pricing than continental Europeans did. British industry and labor typically wanted to retain the freedom to set higher prices and strike for higher wages. These freedoms tend to be more restricted in the French system of indicative planning—and in other forms of national planning, even by democratic governments.
- ◀ The Labour Party's vision of the British social welfare system went largely unchanged in the 1950s and 1960s, except the NHS was modified so that people had to make small copayments for glasses, contact lenses, false teeth, and prescription drugs. Children, the elderly, and the poor were exempt from these charges.
- ◀ The last Labour government of the 1970s engaged in one last round of industry nationalizations. British Petroleum and Rolls Royce were nationalized—not for planning or stabilization reasons, but mainly because they were on the verge of bankruptcy at the time. Government bailouts in the form of nationalization was a way to save the companies and the jobs of the people who worked there.

## Economic Distress

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- ◀ In most industrial democracies, the 1970s was a time of stagflation, which refers to the combination of economic stagnation—that is, a lack of growth—occurring at the same time as inflation drives costs and prices higher.
- ◀ Most economists believe that inflation occurs as a result of rapid growth, low unemployment, and high demand for goods, services, and workers. If the economy is stagnating, or declining, the level of prices should be dropping as people and businesses spend less.

- ◀ The major cause of the economic stagflation of the 1970s was the oil embargo imposed on the United States and some other Western nations by the Organization of Arab Petroleum Exporting Countries. These Middle Eastern members of OPEC (Organization of the Petroleum Exporting Countries) relied almost entirely on petroleum sales to finance their national economies. The effect was to significantly restrict the supply of oil to industrial countries and, therefore, to drive up the prices of gasoline and everything else.
- ◀ Gasoline prices in the United States doubled in 1973, and doubled again in 1979. For industries and households in industrial democracies, the effects of the oil shock were devastating. Any manufactured product that took energy to produce became much more expensive. Anything shipped by air, rail, or truck cost much more to transport.
- ◀ British industries were older—and energy inefficient—and therefore at a severe competitive disadvantage. Prices in Britain increased by as much as 17 percent per year in the late 1970s. British factories, mines, and shipyards laid off workers by the hundreds of thousands.
- ◀ In response, two competing explanations—and suggested cures—were offered to address Britain's economic distress.
  - ◇ The Labour Party blamed the capitalist system and argued for more Keynesian-style fiscal and monetary stimulation. They wanted to increase the money supply and expand government spending to put Britain back to work.

- ◇ The Conservative Party blamed the welfare state: high taxes and inefficient publicly owned enterprises. Conservatives believed that high taxes led to elevated prices while also reducing incentives to invest in new ideas. They argued that inefficient state-owned enterprises produced substandard goods and services that were uncompetitive in world markets.

## The Thatcher Government

- ◀ The 1979 election was a contest between these two vastly different visions. The Conservative Party, led by Margaret Thatcher, won the election and radically remade the British welfare state that William Beveridge and the Labour Party had created.
- ◀ The Thatcher government significantly reduced taxes, especially on higher-income Brits. Thatcher broke a strike of the miner's union and reduced the powers of trade unions in general. She also pushed through deregulation of the financial industry, which led to booming business in the London financial sector and high incomes for British financial professionals. The Thatcher government also privatized many government-owned enterprises.
- ◀ Many Brits became quite wealthy and successful as a result of Thatcher's policies. London became a magnet for entrepreneurs and businesspeople. One negative result of the Thatcher years was a large increase in income inequality in Britain.



- ◀ The one sector of the British social welfare system that the Thatcher government didn't touch was the NHS. The NHS had such strong public support that even in the midst of free enterprise euphoria and mass privatizations, William Beveridge's prize creation remained a publicly owned institution.
- ◀ The Conservative Party ruled Britain from 1979 to 1997. Near the end of its reign, the British electorate became less enchanted with the free market direction of Thatcherite policies and elected a Labour Party government in 1997 led by Tony Blair.
- ◀ Blair ran as a candidate from "New" Labour. He didn't reverse any of the Thatcher nationalizations. But his government did raise minimum wages, unemployment benefits, and old-age pensions. The Labour Party won three elections and governed until 2010, when a new Conservative government led by David Cameron took over.

## Readings

BEVERIDGE, *Full Employment in a Free Society*.

WEBSTER, *The National Health Service*.

## Questions

- 1 After World War II, the British voters threw out the government of Winston Churchill and elected a Labour Party government. What did the voters want?
- 2 The British have a system of national health care that is almost completely government owned and controlled. What are the advantages and disadvantages of this system compared to the American health-care system?




## *Lecture 15*

# Social Welfare in Germany: Bismarck to Kohl

**T**HE OCCUPATION OF GERMANY AFTER WORLD WAR II had profound effects on the country's postwar development, beginning with the creation of two new countries: the German Democratic Republic (East Germany) and the Federal Republic of Germany (West Germany). This division, at least temporarily, undid the unification of Germany that Otto von Bismarck had accomplished less than a century earlier. Bismarck combined 39 independent states under his leadership in Berlin. He was also the founding father of the German social welfare system. In fact, he was the first political leader in the world to create national systems of unemployment insurance, old-age pensions, and health care. ♦

## Bismarck's Health-Care System

- ▶ Otto von Bismarck believed in German development and German power. He was a driver of German industrialization and technological development. He understood that modern military power is based on industrial capability and advanced technology. Additionally, he was motivated by his Lutheran beliefs and the duty of the rich to help the poor.
- ▶ Bismarck understood that any worker who feared losing his or her job—and income—would not be the most productive employee. Furthermore, workers who were unhealthy and had no care when they were sick would hold back national economic development. And when workers retired, they would need incomes to support themselves in old age. So, Bismarck devised systems of worker protection and worker development in the German Reich. These policies also helped diminish the appeal to workers of the rival Social Democratic Party.
- ▶ Bismarck was an enemy of all political parties, because they challenged his hold on power. He was also an enemy of the Catholic Church, which he saw as too reactionary and conservative. The Catholic Church promoted a quiet rural life of obedience, but Bismarck needed Germans to move to the cities and take up jobs in the new factories of industrializing Germany.
- ▶ Bismarck's health-care system, created in 1883, required all employees to contribute a share of their wages to pay for workers' health insurance. And he required employers to pay an equal amount into the system for each employee. If a German worker loses his or her job, unemployment benefits take over the burden of making the health insurance contributions. So, a German worker doesn't lose health care when a job is lost.



In the present-day German health-care system, employees and employers each contribute the equivalent of 7.5 percent of the worker's wage.

- ◀ The premiums are paid to so-called sickness funds, which are nonprofit organizations required to accept all applicants. They earn no profits, but their executives are compensated based on the number of their members, so there is some incentive to compete for new members.
- ◀ The Bismarck system of health care and social welfare lasted through two world wars as well as through political upheavals and the dictatorship of the Third Reich. And it remains the basis for unified Germany's system of social welfare.

## **Development of the New Federal Republic**

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- ◀ Today's Germany went through an uncertain and difficult division after World War II. Once fighting stopped, the Allied military commands were the supreme powers in Germany. And between the end of the war in 1945 and the establishment of the Federal Republic in May 1949, several different scenarios were advanced by the Allied powers and German politicians.
- ◀ There was strong sentiment in both the United States and the Soviet Union to deindustrialize Germany and return it to the rural and agricultural land it had been before Bismarck. But there were also major factors militating against this plan. France, Britain, and other economies in western Europe needed German industrial goods to rebuild their economies. They also needed German consumers and businesses to buy their exports.

- ◀ Although the United States and the Soviet Union had been allies in World War II, differences and disputes developed almost as soon as the war ended. Not only was Germany divided into four zones of occupation, but Berlin—the capital, deep inside the Soviet zone—was itself divided into four zones of occupation and administration. And the Soviets wanted the other three Allied powers—Britain, France, and the United States—to leave Berlin under direct and total Soviet control.
- ◀ The United States and the Soviet Union also disagreed about the nature of governments and economic systems in eastern Europe, which were now under the complete control of the Red Army. The Cold War was developing, and the Soviet Union and the United States were becoming adversaries rather than allies.
- ◀ Political parties and movements inside Germany had very different opinions and political platforms than those expressed by their occupiers. The Social Democratic and Communist Parties wanted an untied, neutral, and socialist Germany. Conservative parties, businesspeople, and professionals wanted a market-based liberal democracy.
- ◀ Trade unions wanted a market economy, but one in which there were highly developed social welfare policies and regulations. And there were some who wanted a return to the militaristic and dictatorial system of the Third Reich.
- ◀ For the three Allied powers governing in the west, there were immediate and serious short-term problems to be overcome. There were millions of hungry, unemployed, and homeless Germans. Additionally, there were millions of displaced Germans streaming into the western zones of the country from eastern Europe.

- ◀ In addition, there was a money problem. The old reichsmark of the defeated Germany was becoming more and more worthless as prices rose. To counter postwar inflation, the Allied powers and the interim western German government carried out an overnight currency reform. Old reichsmark—up to 400 of them—could be traded in for the new deutschmark at a ratio of 10 old marks to one new mark. This wiped out lots of paper financial wealth. But it had a galvanizing effect on the western German economy.
- ◀ The Soviets objected mightily. More than any other factor, the new currency led to the establishment of a formal government, and national state, in western Germany. The Soviets countered by founding the German Democratic Republic in their zone. This two-state system was to last until 1989, and the fall of the Berlin Wall.



Modern monetary economists define hyperinflation as any inflation rate above 50 percent per year. In the 1920s, Germany had inflation rates in the thousands of percent.

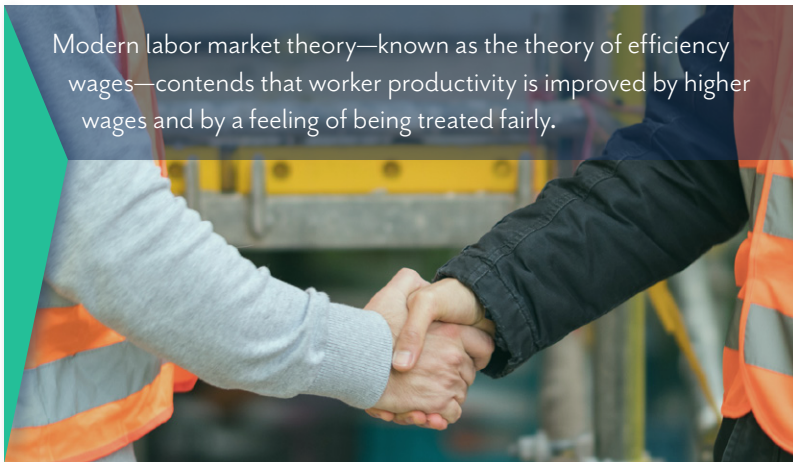


The rapid development of West German capitalism had some unsavory aspects. Many business leaders and industrialists who had actively supported—and profited from—the Nazi regime were not prosecuted for war crimes. Others were let out of prison early and allowed to reestablish themselves as business leaders in the new republic.

- ◀ The other major factor in the rapid development of the new Federal Republic was the Marshall Plan. Formally known as the European Recovery Program, it's better known today for its association with U.S. Secretary of State George C. Marshall.
- ◀ With the Marshall Plan aid and a stable currency, the West German economy took off and was the fastest-growing economy in Europe. It also had an unexpected benefit as the result of its wartime destruction: West German factories were now rebuilt with the most modern and up-to-date equipment. German industry had an advantage over British and French industry, which still worked with older equipment.
- ◀ West German industry received a great deal of investment funding from its large banks. German citizens tended to be rather conservative and risk averse. Therefore, they preferred the safety of banks, which guaranteed set—if low—interest rates to the relative risk of investing their savings in stocks. In turn, the banks lent depositors' savings to German businesses. This relative freedom from short-term pressure gave German business leaders a greater chance to pursue longer-term strategies and growth projects.

- ◀ Even though the West German economy was based on a laissez-faire market system, the German government still played a large role. Some German industries—such as the German rail system and German utilities—were dominated by publicly owned enterprises. Additionally, some firms, such as Volkswagen, were owned primarily by private stockholders but with some additional stake held by the government.
- ◀ All large German enterprises with more than 500 employees were required to have members of the relevant trade union, representing workers in its industry, on its board of directors. This principle—called *Mitbestimmung*, or codetermination—gives German workers a voice, and a stake, in the long-term success of their employer.
- ◀ German workers typically are well paid. Germany also typically has among the largest trade surpluses of any country in the world. To simultaneously have high labor costs and a large trade surplus means that German workers are highly productive. And productivity depends on education and skills.

Modern labor market theory—known as the theory of efficiency wages—contends that worker productivity is improved by higher wages and by a feeling of being treated fairly.



## German Education and Business

- ▶ The German educational system does an excellent job of preparing students for the workforce. Moreover, hiring firms frequently are subsidized by the federal government, which bears some of the expense of employing younger and less skilled workers. As a result, youth unemployment rates in Germany are among the lowest in the world. This early connection to the labor force builds lifetime skills and ever-higher productivity.
- ▶ German labor law is also much different than U.S. labor law. In the United States, many jobs in the private workforce are let under a system that allows employers to hire and fire at will. U.S. employers typically have few regulations that constrain them from terminating individual workers.
- ▶ In Germany, by comparison, firms that intend to lay off workers undergo a long process of notification, appeal, and generous severance payments. This typically makes German firms reluctant to fire workers, but also quite conservative in taking on new ones.
- ▶ So, the typical German firm's labor-turnover ratio is much lower than for a U.S. firm. This longer attachment to a single employer means that the typical German firm enjoys the benefits of the training and education it provides to its workers longer than a U.S. firm does.
- ▶ This internalization of the growth of human capital is among the secrets of high German labor productivity. Because a German firm expects its worker to remain with it for a longer period of time—to the firm's benefit—it's more willing to train its workers.

- German workers also get a lot of time off. There's some evidence that a generous vacation and leave policy tends to create more rested, healthier, motivated, and productive workers. German workers aren't too stressed out about unemployment, old-age incomes, or bouts of illness and injury, and less stress tends to promote better health and longer life expectancy.
- Germans who attend a university tend to stay in school longer. There's no tuition, and university students get payments either from their parents or from the government. German university students enjoy highly subsidized meals, transportation, housing, and entertainment, so it's not unusual for German students to remain in university full time until their late twenties.
- Helmut Kohl—who was the chancellor of West Germany and then reunited Germany for 16 years, from 1982 to 1998—often complained that Germany was becoming a *kollektive Freizeitpark*: a collective amusement park, where nobody worked. However, attempts to impose tuition charges and maximum lengths of study have met with furious resistance from students' unions as attacks on academic freedom.
- Although the German government regulates employment and prices and subsidizes health care and education on a large scale, it does not tell German businesses what to produce. Planning in Germany has too many echoes and negative connotations from the Nazi period, when industry was tightly planned to provide for the war machine of the Third Reich. Long-range economic planning—to the extent that it exists at all—is done by the larger German banks and large industrial conglomerates.



- ◀ Even though Germany has many large world-class firms, it also has a large and thriving sector of small- and medium-size firms. This is the so-called *mittelstand*. It consists mainly of family-owned firms that specialize in specific high-quality consumer and industrial products. They benefit from the vocational education and apprenticeship programs.
- ◀ All German firms, whether large or small, must belong to some business federation. Very large companies belong to the Federation of German Industries. Others belong to the Association of German Chambers of Industry and Commerce, which has affiliates all over the world.
- ◀ The German business chambers are the main organizations that supervise the country's student-worker apprentice programs and establish the criteria for professional exams and licensure. Almost all German workers—whatever their trade or occupation—have a professional license, or permit, that was obtained through specific education, training, and examinations.
- ◀ There are some hidden characteristics, or costs, to the Germans educational system, too. One criticism is that early placement into a vocational track tends to reinforce social-class distinctions and income inequality. Students from upper-class families tend to track into academic secondary education, in college preparatory schools. Working-class young people tend to track into vocational schools and blue-collar occupations.
- ◀ Another major cost is that German tax revenues pay for the employer subsidies. Partly as a result, Germans pay significantly higher taxes than Americans. The overall tax rate in Germany is about 45 percent, compared with about 32 percent in the United States.

## Readings

BERGHOFF, KOCKA, AND ZIEGLER, EDS.,

*Business in the Age of Extremes.*

CRAIG, *The Germans.*

## Questions

- 1 Why was the Marshall Plan good for the post–World War II West German economy and good for the U.S. economy?
- 2 How do German labor market laws and institutions create incentives for German businesses to improve their workers' skills and productivity?



## Lecture 16

# Soviet Bloc: Conformity and Resistance

**A**S WORLD WAR II WAS ENDING, THE ALLIED VICTORS began to negotiate the postwar fate of Europe. The two major triumphant powers—the United States and the Soviet Union—were advancing toward Germany and ultimate victory over the Nazi regime. Yet the United States and the Soviet Union had very different histories in this war. The United States had begun its most important military offensive in Europe as recently as June 1944. By comparison, the Soviet Union had borne the brunt of German attacks, beginning three years earlier. ♦



Estimates of Soviet losses in World War II range from 20 million to 30 million human lives lost.

## Soviet Communism

- Because of Soviet sacrifices at the hands of the German army—and Soviet victories over the Germans—the Soviet Union felt entitled, at the end of the fighting in Europe, to dictate the nature of economic and political systems in the territories that the Soviets occupied. In addition, the Soviet Union and communist parties elsewhere in Europe could count on large numbers of voters in postwar elections, in part due to Soviet resistance to the Nazis.
- In the Czechoslovakian elections of 1946—the last free elections in Czechoslovakia for decades to come—the Czechoslovak Communist Party got almost 40 percent of the vote. Similarly, in eastern Germany, the socialist and communist parties enjoyed significant support. In short order, Stalin and his proxies across eastern Europe would cynically use this support to consolidate political power in eastern Europe and eliminate democratic opposition.
- By the end of the 1940s, they had quashed all open opposition, with one exception. In Yugoslavia, Marshal Tito had led an independent army of national liberation against the Nazi army during wartime. As the leader of his own independent military force, Tito was now able to develop a fairly independent political base of power and strategy for governing Yugoslavia.
- So, of all the eastern European countries that subsequently were organized as communist economies, Yugoslavia was the most independent—and most different—of the bloc nations. Its economy was the most decentralized, and its foreign policy was the most self-directed.

- ◀ The Soviets ceded control in most other areas of the Balkans. The British were granted hegemony in Greece, where large socialist and communist parties had led the fight against Germany. Now, on Stalin's orders, they gave up their opposition to a British-installed capitalist government and economic system there.
- ◀ The remaining nations of eastern Europe—Poland, East Germany, Czechoslovakia, Hungary, Rumania, and Bulgaria—came to be completely dominated by the Soviet Union. Their Soviet-style political and economic systems were enforced by the Red Army, on orders from the Soviet government and their proxies, in the form of carefully chosen national political leaders.
- ◀ The leading communist parties in the various eastern European communist countries went by different names, but they were all carbon copies of the Soviet Communist Party in structure and style and in the complete control they exercised over the countries they governed.

## **The Soviet Economic Model**

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- ◀ Every eastern European country under Soviet domination not only adopted one-party authoritarian states, but they also adhered to the basic Soviet economic model. This model had several common components, including state ownership of all major economic sectors, collective or state-owned agriculture, comprehensive planning, and an emphasis on industrial development.
- ◀ There would be no scope for private ownership or market-directed economic incentives. No profit or dividend income would be allowed. No independent financial sector or financial markets were tolerated. All labor would be allocated by state planning agencies. And foreign trade was under direct state control.

- ◀ While the Soviet Union gradually consolidated its command over the eastern European communist economies, the Western allies—led by the United States—rebuilt market-oriented economic systems that had frayed as a result of the Great Depression and World War II.
- ◀ They also created new international economic and financial institutions to help coordinate international relations. The recently created International Monetary Fund (IMF) would facilitate and supervise the international movements of money and financial capital. The World Bank would lend money to finance the reconstruction of Europe.
- ◀ The Organisation of European Economic Co-operation (OEEC) was established to coordinate the distribution of U.S. financial aid. This aid was formulated under the congressionally approved European Recovery Program of 1948, better known as the Marshall Plan, named for U.S. Secretary of State George C. Marshall. The OEEC laid the groundwork for the European Economic Community, or Common Market, that came into existence in 1957.
- ◀ Although eastern European countries such as Poland, Czechoslovakia, and Hungary were receptive to receiving much-needed American financial assistance—and were eligible for it under the Marshall Plan—the Soviets feared U.S. influence and the strings that would be attached to such aid. So, the Soviets blocked its extension to communist allies in eastern Europe.
- ◀ Another post-World War II organization—the North Atlantic Treaty Organization (NATO), founded in 1949—was formed to defend western Europe from future aggression. And the United Nations, founded in October 1945, would try to settle international conflicts peacefully.

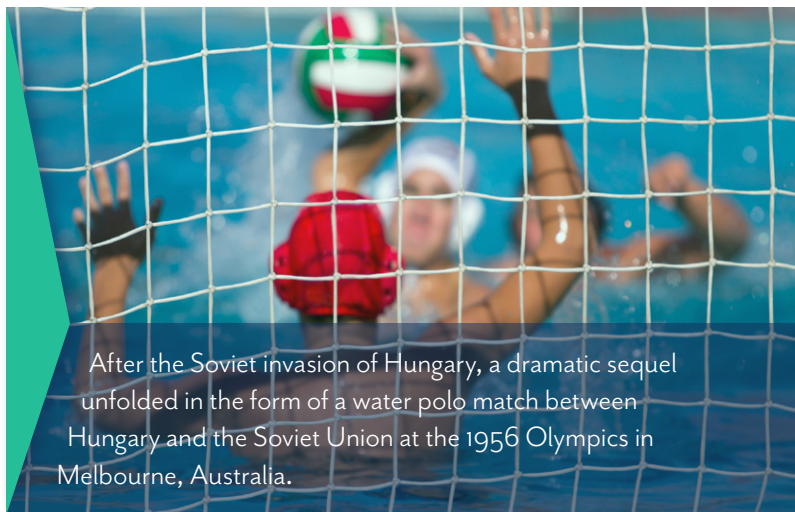
- ◀ The Soviet Union was initially invited to join the IMF and the World Bank, but declined membership—again, for fear of U.S. influence and domination. The only one of the new international organizations the Soviets decided to join was the United Nations.
- ◀ After NATO's founding, the Soviets created a competing military alliance, the Warsaw Treaty Organization, as a counterweight. The Soviets also established a competing international economic body, the Council for Mutual Economic Assistance, known as Comecon and headquartered in Moscow, that directed trade among the Soviet-dominated economic systems of eastern Europe.
- ◀ Comecon claimed to be the eastern equivalent of the Common Market being developed in western Europe. But it was not a facilitator of private trade based on comparative advantage. Instead, Comecon served as a planning agency that oversaw essentially a barter system of trade among the countries of eastern Europe and the Soviet Union. This trade was based primarily on Soviet needs and the political decisions of the leadership of the Communist Party of the Soviet Union.
- ◀ Each eastern European communist economy was oriented to emphasize heavy industry, just as the Soviets had done in their initial five-year plans. Consumer goods and services were given very low priority. Labor, raw materials, and capital goods were to be devoted, instead, to building up large-scale industrial enterprises that would be directed by a planning bureaucracy that answered to the political leadership of the country—the Communist Party.
- ◀ Each eastern European economy was also directed to concentrate on specific industrial sectors. East Germany, for example, had the task of producing railroad rolling stock for the Soviet Union. Poland was given the task of producing coal and steel. Hungary was assigned the task of producing buses.

## Revolt against Soviet Domination

- ▶ An authoritarian state that suppresses all dissent is required to also suppress the production of consumer goods and services and eliminate political opposition. In the Soviet Union and much of eastern Europe during the late 1940s and early 1950s, there were show trials, imprisonments, and executions of political oppositionists who did not follow strict party orders. Many refugees fled from the oppression and lack of freedom.
- ▶ A solid border formed between eastern and western Europe to stem the flow of refugees. Winston Churchill, having only recently been voted out as the British prime minister, described—in his famous 1946 speech in Fulton, Missouri—an “iron curtain” that had descended on Europe. This Iron Curtain was to divide Europe for more than 40 years.
- ▶ On one side would be the rapidly recovering economies of western Europe, with their increasing abundance of consumer goods. On the other side would be the gray and much poorer economies of eastern Europe, cut off from their neighbors—not only economically, but culturally and politically.
- ▶ While the Soviet economy and its eastern European satellite states were inefficient and not very dynamic, significant disruption was bubbling up from time to time. These sporadic protests and internal dissent were driven by the dissatisfaction of the general population with their standards of living and the lack of political and cultural freedom.
- ▶ There were violent uprisings and protests in all eastern European states. The first was East Germany’s in 1953. Economic authorities in East Berlin—to speed up economic development and industrial production there—had mandated increased production quotas

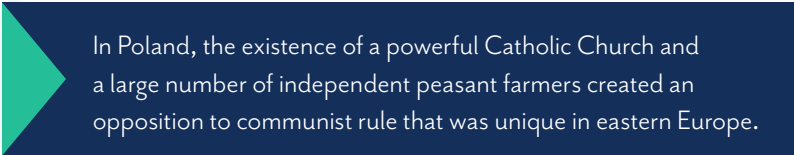
for industrial workers without any corresponding increase in pay. Not surprisingly, workers in East Berlin revolted, and were put down with military force.

- ◆ The next major uprising against Soviet domination and control came in Hungary in 1956. This revolt was much more violent, bloody, and prolonged. It began as a student protest for greater political and cultural freedom. Tens of thousands of students took to the streets of Budapest, and they were fired on by state security forces. This inflamed the population. The revolt spread throughout Hungary. Eventually, Soviet troops were called in to put down the revolt. More than 2,000 Hungarians and 700 Soviet soldiers were killed. Thousands of Hungarians subsequently fled west and flooded refugee camps in Austria, Germany, and Switzerland.
- ◆ Meanwhile, a worker uprising centered in the Polish city of Poznan also unfolded in 1956. The spark was similar to that of the East Berlin uprising in 1953. Workers were given orders to



After the Soviet invasion of Hungary, a dramatic sequel unfolded in the form of a water polo match between Hungary and the Soviet Union at the 1956 Olympics in Melbourne, Australia.

increase production with no corresponding increase in pay. The Polish United Workers' Party—the name of the communist party there—responded by calling out troops. But, in a tacit challenge to Soviet hegemony, it also replaced the political leadership with a reformer named Władisław Gomułka. This uprising was put down relatively peacefully, but only after Gomułka personally assured Soviet leader Nikita Khrushchev that Poland would remain a loyal Soviet ally.

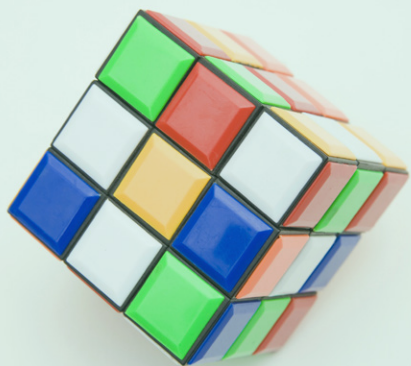


In Poland, the existence of a powerful Catholic Church and a large number of independent peasant farmers created an opposition to communist rule that was unique in eastern Europe.

- ◀ The next major revolt against Soviet domination and the authoritarian system of government came in Czechoslovakia during 1968, when the Czechoslovak Communist Party was under the direction of First Secretary Alexander Dubček, who now allowed significant freedom of expression in the form of novels, plays, and especially films. This wave of creativity and criticism was called the Prague Spring.
- ◀ In response to some films that were overtly critical of the Stalinist economic and political system imposed on Czechoslovakia, the new Soviet communist leader, Leonid Brezhnev, proclaimed the Brezhnev Doctrine, which asserted a right to intervene in the domestic affairs of Warsaw Pact member states if the existence of communism there were threatened. Under this pretext, Warsaw Pact forces led by the Soviet army invaded Czechoslovakia in August 1968 and crushed the Prague Spring. For more than 20 years to come, Czechoslovakia was a relatively grim and oppressive country that suffered the loss of many of its citizens, who fled west to freedom.

The year 1968 was a revolutionary one in many parts of the world. Student riots paralyzed France and challenged the grip on power of the 78-year-old Charles de Gaulle. Mass protests rolled across the globe—from Chicago to London, Mexico City, and elsewhere. In the United States, these protests centered principally on the war in Vietnam and erupted in the form of violent protests during the Democratic National Convention in Chicago.

- ◀ Another reform movement in 1968 was launched in Hungary. Unlike Czechoslovakia's Prague Spring, which had a political emphasis, the New Economic Mechanism in Hungary concentrated on economic reform. And it permitted no independent cultural or political criticisms. It did, however, allow for some small private enterprise activity, mainly in the consumer goods and services sector. The Hungarian economic reforms—despite some success—failed to arrest a decline in the living standards of Hungarians relative to the living standards in neighboring Austria.



The ultimate consumer good that communist Hungary produced was a color-coded puzzle created by the amateur mathematician Erno Rubik known as the Rubik's cube.

## Readings

DRAKULIC, *A Guided Tour through the Museum of Communism*.

——, *How We Survived Communism & Even Laughed*.

PLOKHY, *Yalta*.

## Questions

- 1 How did the communist economies of eastern Europe mimic the economic system of the Soviet Union? What problems did this imitation create in eastern Europe?
- 2 Were eastern European communist countries always quiet and peaceful? Were they unchanging, static societies under Soviet domination?



## *Lecture 17*

# Two Germanies: A Laboratory in Economics

**A**T THE END OF WORLD WAR II, THE VICTORIOUS Allies had no clear idea of what kind of postwar Germany they wanted to create. Above all, the United States didn't want to repeat the mistakes of the Versailles Treaty, which had ended World War I by imposing harsh financial reparations and major territorial realignments. Yet three major conferences of Allied powers, taking place near the end of the war and afterward, left the German question unresolved. ♦

## Postwar Germany

- ◀ The Allied armies of the Soviet Union and the United States concluded World War II deep inside German territory and facing each other fairly close to the Elbe River. This would prove to be the eventual border between East and West Germany. Initial conceptions for the conquered European power included a united but neutral Germany.
- ◀ The original U.S. proposal was to deindustrialize, and de-Nazify, Germany and turn it into an agricultural and rural country. This was the Morgenthau Plan, proposed by President Franklin D. Roosevelt's secretary of the treasury, Henry Morgenthau. The plan was a punitive approach to Germany's postwar development.
- ◀ The major problem was that Germany had to feed, clothe, and house itself. And the population was swelling with the arrival of millions of refugees fleeing from the Soviets in the east or being displaced by Czechs and Poles in formerly German-occupied lands.
- ◀ Germany's occupying powers—the United States, the Soviet Union, France, and Great Britain—now divided Germany into four postwar occupation zones.
  - 1 The U.S. Army occupied the southern half of the country, including the federal states of Bavaria, Rhineland-Palatinate, Baden-Württemberg, and Hessen.
  - 2 The French occupied the far western part, along the Rhine river.
  - 3 The British occupied the northwestern quarter, including the cities of Hamburg and Bremen.

- 4 The Soviets occupied the northeastern quarter, including the former capital of Berlin, which itself was divided into four zones of occupation under a combined military command.
- ◀ The location of Berlin deep inside the Soviet zone was to prove problematic, significantly as the Soviets demanded huge war reparations from Germany in the form of money, industrial equipment, and other resources; and as the United States, in early 1946, halted the movement of these reparations to the Soviets across the American occupation zone. Shortly after this, the United States, France, and Germany consolidated the three western zones of occupation.
  - ◀ As negotiations with the Soviets broke down, in June 1948 the Soviet Union imposed a blockade on Berlin of all road, railway, and canal movement into Berlin, including into parts of the city that remained under the occupation and control of the other Allied powers.
  - ◀ Consequently, the combined U.S., British, and French zone became the Federal Republic of Germany—that is, West Germany—in May 1949, with the Rhineland city of Bonn as its provisional capital. In October 1949, the Soviets responded by creating the German Democratic Republic—East Germany—with its capital in the Soviet zone of Berlin: East Berlin.
  - ◀ The Soviets still held out the possibility of creating a neutral, nonaligned, united Germany. But as the Cold War developed, and as West Germany was incorporated into the North Atlantic Treaty Organization, the existence of two Germanies became more and more of a reality.

## The Economy of West versus East Germany

- West Germany (the Federal Republic) benefited economically in several ways, in contrast to East Germany, sometimes known by its German initials as the GDR.
- West Germany benefited from the presence of American troops in a large part of the country. Although the Europeans sometimes complained about American soldiers, the soldiers did have money to spend. This spending—by individual GIs and the U.S. military—was a significant stimulus to West German agriculture, its consumer goods makers, and workers employed on U.S. bases.
- Additionally, the Federal Republic began to receive redevelopment aid under the congressionally approved Marshall Plan. In comparison, postwar France and England were destitute countries with scarcely enough resources to feed, clothe, and house their citizens.
- Neither the British nor the French had resources to provide more than basic relief for the German populations under their control. And the Soviets were dismantling East German industrial capacity and taking it back home. In effect, the Red Army was “undeveloping” East Germany.
- Furthermore, because Joseph Stalin did not allow Soviet-allied countries to receive Marshall Plan assistance, the GDR was all the more handicapped in its attempts to recover from the war.

- ◀ A final brake on East German economic development was the occupying Soviet administration's intent to create an economy in the GDR that nearly exactly replicated the Soviet system. This meant the collectivization of agriculture, with all the disincentives that created.
- ◀ In every country that adopted a Soviet-type agricultural system, food-production problems were chronic. Collectivized and state-owned agriculture has been a failure everywhere it's been tried, without exception. Farmers produce more efficiently when they own their own land and reap the economic rewards of their efforts.
- ◀ The Soviets also demanded that the GDR government nationalize all enterprises with more than 50 employees and create comprehensive plans for production and distribution. In state-owned economies devoid of economic incentives, large-scale enterprises tend to be grossly inefficient.
- ◀ So, the relative deprivation of East Germany—and especially the formerly rich cities of Berlin, Leipzig, and Dresden—was cruelly ironic. Along with Hamburg, these cities had been the centers of opposition to Hitler and the Nazi regime. Hitler despised the big German cities of the north. He thought they were full of socialists, Jews, homosexuals, foreigners, creative modern artists, and musicians—so-called undesirables.
- ◀ Hitler's support was mainly in the south, closer to his native Catholic Austria. So, just as the cities of Berlin, Leipzig, and Dresden were punished the most severely for the crimes of Hitler and the Nazi regime, it's doubly ironic that southern and southwestern Germany enjoyed the biggest postwar benefits.

## The Berlin Wall

- After the Berlin wall fell in November 1989 and West Germans began to lecture their eastern brethren on some of their failings (and also look down on them for their relatively low standards of living), East Germans with a stronger historical foundation reacted with anger and outrage at the smugness and historical ignorance of their western cousins.
- There were large differences in the productive efficiency of East versus West German enterprises, and the gap between West and East German productivity continually widened through East Germany's 40-year history.
- The GDR economy was the most productive in the Soviet bloc. East Germany tended to be the most technology-intensive producer. It manufactured railroad equipment, telephone equipment and systems, and office equipment, among other industrial goods. East Germany was also the Soviet bloc's principal producer of chemical products.
- To control East Germany's population and prevent outright opposition, the Red Army posted more than 10 percent of its total eastern Europe troop deployments in the GDR. The governing party of the GDR, the Socialist Unity Party, depended on the presence of large numbers of Soviet soldiers to maintain its hold on power. The Soviet Union needed the GDR to be a model communist state and a dependable buffer against the West.
- The absence of private enterprise and ownership in the GDR was accompanied by rigid censorship of the arts and culture. Dissident writers, poets, and singers were harassed, denied ration cards, and often jailed. There was even an attempt to create appropriate popular music—socialist music—in contrast

to the decadent and subversive jazz and rock and roll coming from the West. This absurd, and unsuccessful, attempt to turn East German citizens away from Western pop music ultimately played a key role in the GDR's collapse.

- ◀ In June 1953, East German workers spilled out onto the streets of East Berlin, and hundreds of other towns and cities, to protest orders to increase production with no increase in pay. This was the first postwar uprising in any of the Soviet bloc countries against the new economic and political system imposed on them by the Red Army.
- ◀ The GDR government had to call on Soviet troops to put down the revolt. More than 20 demonstrators were killed, and thousands were put in prison. As a result, thousands of East Germans began to flee west.
- ◀ By the middle of the 1950s, the West German economy was producing abundant amounts of food, clothing, and other consumer goods. This was the beginning of the West German economic miracle: the *Wirtschaftswunder*.
- ◀ More than 2.5 million East Germans fled to the West between 1949 and 1961, and they tended to be younger, more educated workers—the ones most needed to develop the economy.
- ◀ In August 1961, the East German government began to build a barrier that eventually would enclose the people of East Berlin inside a solid wall: the Berlin Wall. It was actually two sets of barriers. One was built between East and West Berlin, and the other was erected all the way around the city of West Berlin to separate Western territory from the Soviet bloc GDR. West Berlin was, thus, established as an island of democracy and freedom deep inside East Germany.



- ◆ The East German government and the Soviet military tightly controlled transit between West Berlin and West Germany. Western aircraft were granted only three flight paths, and only three Western airlines were allowed to fly through East German airspace into West Berlin. No West German airlines were given such access. The communists also tightly controlled road and rail access to West Berlin, and sometimes they stopped it entirely.

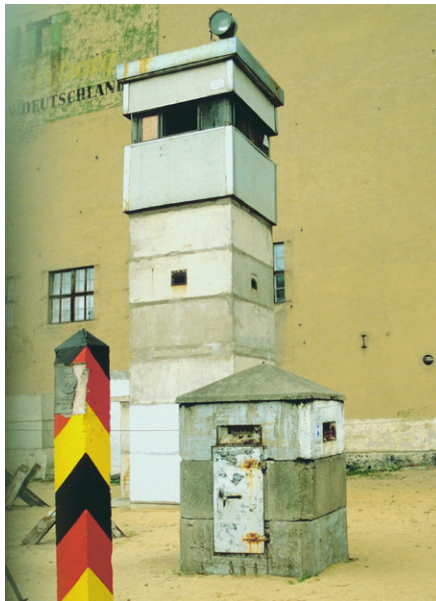
## A Divided Germany

- ◆ With the construction of the Berlin Wall, the two Germanies—and divided Berlin—existed as distinct and opposing systems. In turn, the citizens trapped in the GDR set about trying to make the best of the situation.

- ◀ At first, the conservative West German governments of the Christian Democratic Union adopted a hostile and confrontational attitude. This became formalized as the Hallstein Doctrine, named after a West German state secretary for foreign affairs, Walter Hallstein. The doctrine refused to recognize the GDR as a sovereign state and declared that there was only one legitimate Germany: the Federal Republic to the west.
- ◀ In time, Bonn changed its approach to dealing with the “other” Germany to the east, as the construction of the Berlin Wall—and the stabilization of the East German population—inevitably led to the recognition that the GDR was more durable than anticipated.
- ◀ In 1969, West Germany’s Social Democratic Party came to power, along with the election of former West Berlin mayor Willy Brandt as federal chancellor. The Brandt government extended full diplomatic relations to East Germany, along with the recognition that two independent nations coexisted on German soil.
- ◀ The Brandt government also extended loans and other aid to assist GDR development. In return, the Federal Republic in the west gained the release of some dissidents and some migration of East Germans to the West.
- ◀ The Federal Republic also secured rights to broadcast West German radio and television into East Germany without its signals being jammed or blocked. The ability of many East Germans to now watch West German television affected them quite profoundly.
- ◀ While East Germans had a higher standard of living relative to other eastern Europeans in communist economies, this was not the case in comparison to the West. And East Germans typically

did not compare themselves to their socialist brothers and sisters in Bulgaria or Romania but rather to their cousins, aunts, and uncles in West Germany.

- ▶ The East Germans watching West German television could now watch and listen to West German news reports and documentaries. This uncensored news and information, along with the alternative view of life in the capitalist West, was unique among the countries of the Soviet bloc. And it was one of the main reasons that the revolts against communism, culminating in the collapse of the Soviet bloc, would begin in the GDR.
- ▶ At the same time, the Berlin Wall—and the comprehensive border between East and West Germany—constituted some of the most solid and technologically sophisticated barriers to human movement ever created up until that time.



The Berlin Wall was eventually so thick that cars and trucks could drive on top of it. It was often 10 feet wide and made of the densest concrete. There was a no-man's-land for 20 or 30 feet on either side of the wall, monitored by East German police with orders to shoot and kill anyone attempting to escape.

## Readings

SCHNEIDER, *The Wall Jumper*.

WOLF, *Man without a Face*.

## Questions

- 1 Who did East German citizens compare their lives and standard of living to? Why did this create problems for the East German communist leadership?
- 2 Did West German engagement with East Germany make the East German government stronger? Did East German access to West German media and economic relations between the two Germanies solidify the East German Communist Party's hold on its citizens?



## *Lecture 18*

# The Soviet Union's Fatal Failure to Reform

**N**IKITA KHRUSHCHEV, A FORMER GENERAL secretary of the Communist Party of the Soviet Union, correctly predicted that the Soviet Union would outproduce the United States in concrete, steel, iron, and coal—and by such a degree that the USSR would essentially bury the United States in these products. But by the time this happened, the United States had moved on to create aluminum alloys, plastics, structural glass, and other advanced technological products that replaced many uses for coal, iron, and concrete. This American advance—and Soviet stagnation—gives a hint of why, over time, the Soviet Union fell further and further behind U.S. ingenuity and prosperity. ♦

## From Khrushchev to Gorbachev

- ◀ Nikita Khrushchev was a complicated—and contradictory—man, and the Soviet politburo (the principal policy-making committee of the Communist Party of the Soviet Union) ousted him from his leadership position in October 1964. Prior to this, Khrushchev had brought some openness to one of the world's most closed political and economic systems.
- ◀ He did so, in significant part, by giving a speech to the party congress in 1956 detailing the horrific crimes of his brutal predecessor, Joseph Stalin. In 1962, Khrushchev permitted the publication of Alexander Solzhenitsyn's *One Day in the Life of Ivan Denisovich*, an autobiographical fiction that exposed the cruelty and misery of prisoners in Soviet penal colonies—the gulag.
- ◀ After Khrushchev was deposed, Leonid Brezhnev became the new leader. And he swiftly escalated the Cold War arms race with the United States.
- ◀ From 1964 until March 1985, when Mikhail Gorbachev assumed power, the Soviet Union was led by a succession of older, and sometimes ailing, men whose preoccupation was maintaining the status quo domestically and achieving military parity with the United States.





Nikita Khrushchev's son Sergei told the story about how his father had ordered the release of millions of Soviet prisoners and therefore had to initiate a mass-housing program. Today, these blocks of concrete can be found in all Russian cities, and in most other countries of eastern Europe.

Sergei said that the original plan was for these blocks to be torn down and replaced with more modern, and aesthetically pleasing, structures in about 20 years. That never happened.

- ◀ Brezhnev's last years—before he died in 1982—were marked by physical and mental decline. He was replaced by Yury Andropov, the former head of the Soviet secret police, or KGB, who had some ideas about reform but suffered from a fatal liver disease and died in February 1984. He was replaced by Konstantin Chernenko, who was also in failing health and died in March 1985.
- ◀ Gorbachev was elected general secretary of the Central Committee of the Communist Party of the Soviet Union on March 11, 1985. The electors were members of the Soviet politburo in Moscow: a committee of nine men at the top of the party. At the time, the average age of a Soviet politburo member was over 70. Gorbachev cut quite the contrasting figure; he had just turned 54. And he was acutely aware of the stagnation, lack of freedom, isolation, and bankruptcy of the Soviet system.

## The Soviet Economy

- ◀ As Soviet general secretary, Gorbachev inherited several serious problems. Military spending, and actions such as the invasion of Afghanistan, were a tremendous drain on the state budget.
- ◀ Soviet soldiers were suffering heavy casualties in the mountains of Afghanistan, and mothers were calling for their boys to be brought home. Additionally, more than half of a million Soviet troops were stationed in eastern Europe, adding to the economic burden on the economy.
- ◀ There were also substantial technological costs, such as maintaining the readiness of Soviet nuclear weapons and its intercontinental ballistic missiles, which weighed on the economy. Some of Gorbachev's key foreign policy decisions would arise from this burden.
- ◀ One of Gorbachev's first priorities became to extricate the Soviet army from what he referred to as the "hopeless military adventure in Afghanistan." On July 28, 1986, he announced the beginning of troop withdrawals, culminating in February 1989. His next foreign policy move was to begin disengaging from direct Soviet control over eastern Europe and reducing the numbers of Soviet troops in all of the Warsaw Pact countries.
- ◀ The withdrawal from Afghanistan and pullback from eastern Europe were also intended to signal interest to the United States and other NATO countries in negotiating reductions in the nuclear arms race. This competition was something that the Soviet Union could no longer afford if it were to use its scarce scientific and technological resources to improve the lives of its people.

- ▶ The Soviet economy was much smaller than that of the United States, even though the two countries had populations of roughly the same size. In fact, the American economy was at least twice as large as the Soviet economy. With comparably lesser resources available to the Soviet economy, distributing that smaller output resulted in a much smaller amount of goods and services for each Soviet citizen compared to in the United States.
- ▶ The Cold War arms race also cost the United States substantially; defense-related production took a large share of U.S. scientific and technological resources. But the American entrepreneurial spirit took many defense-related products and technologies and turned them into modern consumer tech goods and services.
- ▶ In his memoirs, Gorbachev laments the fact that Soviet military factories always had the latest equipment, the most talented engineers, and first claim on economic resources—compared with the outdated equipment and scarce resources available to agriculture and food.



We have the internet thanks to the U.S. Department of Defense, satellite television and telephone communication thanks to the Telstar project, and much of the guts of cell phone technology—as well as the navigational capabilities of GPS—due to military-funded research and science.

- ◀ As the son of collective farmers, Gorbachev had a deep appreciation for the need in agriculture for suitable tractors, harvesters, and trucks to produce and transport the crops that feed a nation. Yet Soviet farm tractors tended to be obsolete, in bad repair, and lacking in the spare parts to repair them when they broke down, which was very often.
- ◀ Furthermore, the Soviet Union was woefully behind in food processing and storage. Milk and cheese often rotted from lack of refrigeration. Bread grew moldy from lack of rapid delivery to retail stores. This also contributed to a shorter life expectancy for the average Soviet citizen.

## Problems with Soviet Planning

- ◀ Gorbachev and his wife Raisa understood that the totalitarian system had limited people's possibilities and imaginations. The conservative mentality had its origins in the nature of Soviet planning. Each person in the Soviet system owed his or her standard of living to the position he or she held. If the person lost that position, he or she could lose his or her home, places to shop, school for his or her children, recreational and cultural opportunities, and medical care.
- ◀ All of this was tied to your position in life. As you went higher up, your standard of living improved. You were eligible for a nicer and bigger apartment. You had more options for vacations. You had access to better food, clothes, furniture, and appliances. So, nobody wanted to lose status in the Soviet system.

- ◀ In market economies, people also lose jobs and their position. But when they lose their job, they don't automatically lose everything else, especially if they can get a job at a different company or organization.
- ◀ But in the Soviet Union, there was no other company or organization. There was no other place to go. The loss of position and status was usually permanent. You would be assigned to a lower position in the same enterprise or moved to a less prestigious place. This was especially true for Soviet managers.
- ◀ The basic operating unit in the Soviet economy was the enterprise. A Soviet enterprise was the equivalent of a single plant, or firm, in a market economy. Unlike General Electric, which has factories all over the world, a Soviet enterprise typically had a single location. And associated with the enterprise were enterprise-linked schools, cultural centers, shops, and apartments.
- ◀ The enterprise manager and his family—it was almost always a man—would get the best and biggest apartment, with access to shops selling Western goods and priority for medical treatment. At the same time, the enterprise manager was given production targets, or objectives, generated by central planning. These targets were always stated in terms of physical quantities and numerical values and would be given in monthly, yearly, and five-year totals.
- ◀ The basic planning tool in the Soviet system was the five-year plan, as instituted by Stalin at the end of the 1920s. Early on, plan targets were pretty simple: so many tons of coal to be mined, so many tons of steel to be produced, and so on. The enterprise manager would be rewarded for meeting the targets or punished for failing to meet the objective.

- ◀ In the Stalin period, not meeting your goal might mean exile to Siberia or worse—although after Stalin died, the major loss for an enterprise manager who did not meet his target would simply be the loss of the job and all the perks that went with that position.
- ◀ Because the targets for an enterprise manager were always set in physical terms, this led to some pretty dysfunctional behavior. For example, if a turbine enterprise manager was given a target of 100 turbines for the month, the incentive would be to produce the smallest turbines possible, even if larger ones were needed.
- ◀ The system of targets produced a strong tendency in enterprise managers to maintain the status quo. If they tried new techniques of production that might possibly be more efficient—and if the new approach failed—then they could lose their jobs.
- ◀ One of the chief criticisms of the Soviet economy was its lack of innovation—in terms of production methods and in range of new products. The typical Soviet manager was not focused on minimizing costs or maximizing sales revenues.
- ◀ In part, that's because Soviet-era managers had every incentive to hire as many workers as possible. More workers meant an easier task of meeting production targets. This created excess demand for labor and was a main reason that there was always full employment in the Soviet Union.
- ◀ Full employment didn't mean efficient use of labor, of course. Often, enterprises would employ workers who didn't do anything but were around in case production needed to be increased quickly to meet the target as the month came to a close. This practice of feverishly rushing to meet the target at the end of each month was called *storming*, and it's a pretty inefficient way to get the job done.

- ◀ Storming leads to shoddy quality of products and exhaustion of the workers. Afterward, the workers might need to rest a bit at the beginning of the next month. And if they rest too long, they will need to storm again. As the Soviet economy developed throughout the 20<sup>th</sup> century, this situation of shoddy and old-fashioned products became worse and worse. People in the West heard stories of Soviet citizens hounding visiting tourists for jeans, portable radios, and makeup.
- ◀ As bad as Soviet consumer goods were, the problem was surpassed by the problem of consumer services. In part, that's because in the Soviet planning system, if you couldn't weigh or measure something, it wasn't counted in the total production figures. So, services didn't get counted as something valuable. Repair services, communication, personal care, restaurants, and retail sales were almost nonexistent in the Soviet economy.

Raisa Gorbachev, the secretary general's wife, was the first spouse of a Soviet leader to have a public persona of her own and to dress in a modern style. Previously, all wives of the general secretary were either completely unknown or photographed just once—in old-fashioned clothes.



## Soviet Failure

- ◀ Gorbachev set out to reform the Soviet system. And that meant giving enterprise managers more freedom to decide output and prices. But because the managers had little or no experience in this kind of decision making, the system became even less efficient and more chaotic. The freedom to set prices touched off rapid inflation.
- ◀ Goods became available, but only at prices that most Soviets couldn't afford. And the ruble itself became worth less and less. Some enterprises even paid their workers in whatever they produced. The entire system of enterprise supply and production broke down, and the scarcity of many goods became chronic.
- ◀ Amid such difficulties, Gorbachev began to allow other Soviet republics—especially the Baltic republics of Estonia, Latvia, and Lithuania—greater latitude. Soon, these republics and the Ukraine and Belarus began to demand complete independence.
- ◀ Finally, on Christmas Day 1991, Mikhail Gorbachev signed the documents that officially ended the Union of Soviet Socialist Republics. Six years after Gorbachev had been appointed the last general secretary, the Soviet Union disappeared off the map of the world.

## Readings

GORBACHEV, *Memoirs*.

MALIA, *The Soviet Tragedy*.

REMNICK, *Lenin's Tomb*.

## Questions

- 1 What were the initial moves made by Mikhail Gorbachev to improve the functioning of the Soviet economy? What were the reasons that he wanted the Soviet Union to change?
- 2 Why did the Soviet Union need to pull its troops out of Afghanistan and eastern Europe? And why did Gorbachev need to negotiate reductions in armaments with President Ronald Reagan?



## *Lecture 19*

# “Blinkered and Bankrupt” in Eastern Europe

**B**Y THE END OF 1989, ALL COMMUNIST GOVERNMENTS in eastern Europe were gone, replaced by semblances of democracy and market economies. In greater and smaller ways, each Eastern European regime had been different and collapsed in different ways. What came after was also different. These differences can best be understood by studying the kind of communist system each at first embraced and then abandoned. ♦

## Eastern European Economies

- ◀ All communist economies of eastern Europe were modeled on the Soviet Union's. Each one nationalized important industries and economic sectors, including agriculture. All adopted five-year economic planning models that emphasized heavy industry and neglected the production of consumer goods and services.
- ◀ This neglect of consumer goods and services was to play a key role in their eventual demise. The lack of attention to, or even regard for, consumer needs and wants became more noticeable, and increasingly aggravating, as the neighboring economies of western Europe took off after World War II.
- ◀ Even in battered Germany—and maybe especially there—the West began to produce prodigious amounts of modern and stylish consumer goods while providing citizens with valuable services, such as housing, entertainment, communications, and retail shopping. What made this disparity so obvious was the availability of Western television and movies to most of the population on the eastern side of the Iron Curtain.
- ◀ Soviet-style economic planners made a conscious choice to limit the production of desirable consumer goods. Instead, the central planners ordered economic enterprises to produce industrial goods and supplies. So, Soviet bloc factories turned out vast quantities of steel, coal, industrial chemicals, cement, electrical equipment, and other industrial goods.
- ◀ Soviet ideology held that industrial growth was the measure of success of a planned economy. So, enterprise managers were rewarded for meeting their production goals. And because the primary objective was maximum production, less attention was paid to efficiency and cost controls.



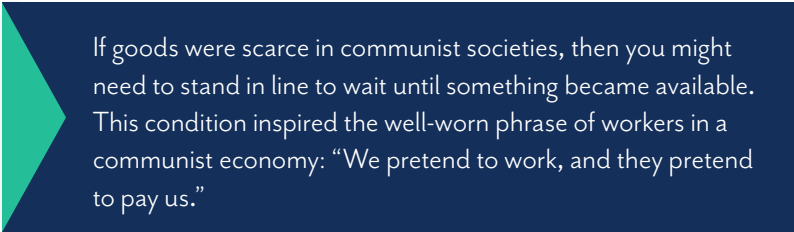
Not only did the Soviet-style economies typically not incorporate computers into industrial production, but computers were ideologically suspect. Soviet ideologues suspected that computer technology was a capitalist plot to subvert socialist planning and information.

- ◀ Communist bureaucrats—whether political functionaries or economic managers—were frequently promoted primarily on loyalty and obedience to authority. There was no tolerance for risk taking or independent thinking. Conformity was a function of the political system and of the ideological control exercised by the ruling Communist Party.

## The Communist System

- ◀ All eastern European societies were one-party, nondemocratic states. The power of the Communist Party—and its leaders in state office—was absolute and not to be questioned. And the top priority of the leadership of the ruling party was staying in power.
- ◀ The system rewarded loyalty, conformity, and group thinking. That's a pretty good recipe for a system that will be stagnant and rigid, without the ability to change or adapt. Large organizations that operate along such lines almost always die out or collapse.
- ◀ The communist embrace of central planning also contained some benefits for ordinary workers. But these benefits were double-edged.
- ◀ Because each manager of an industrial enterprise was rewarded for maximum production, he tried to accumulate the greatest amount of resources he could. This included trying to maximize the size of the labor force that would work at his enterprise. The more workers he had to put on the production line, the easier it would be for him to achieve his production targets. This meant that the entire system incentivized excess demand for labor inputs.
- ◀ Unlike a capitalist enterprise that tries to maximize profits, a communist enterprise had little concern for profits or costs of production. Most communist enterprise managers had no clear idea—and didn't care—what their production expenses were. It didn't affect their success.

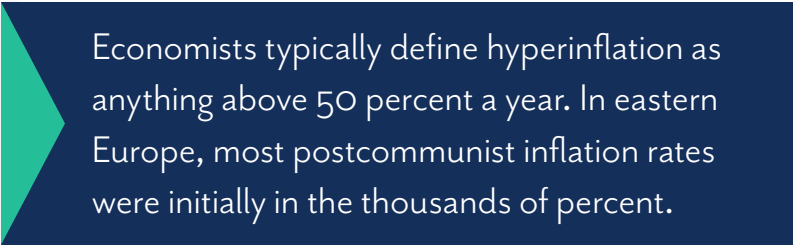
- ◀ One of the cruel things about capitalist enterprises is they're always trying to minimize costs. Often, this means laying off workers who it's thought are no longer needed or who cost too much. But a benefit of occasionally pruning your labor base is that production per worker might increase, and the economy as a whole may be more efficient.
- ◀ Greater output per labor input is the basic driving force for higher standards of living. What a capitalist economy may have to do to avoid mass unemployment is use fiscal and monetary policy to promote economic growth. This growth should provide jobs for workers laid off from other capitalist enterprises.
- ◀ Because a communist enterprise had no need to minimize labor use, or costs, workers were always in demand—and rarely laid off. Jobs were more or less guaranteed.
- ◀ For workers, this has some benefits. Job security is pretty ironclad, so there is no need to stress about unemployment. But self-satisfaction also comes with a cost. Motivation and productive effort might be harder to achieve with workers who have no reason to fear dismissal or transfer.
- ◀ Communist workers were paid a fairly standard wage. This was part of the ideology's promise of equality.
- ◀ Because most communist societies had comparatively undeveloped financial systems relative to those in the West—typically, there were no credit cards, mortgage banks, or consumer loans—a communist country was predominantly a cash society. So, its workers would be paid cash, which they could use to buy whatever consumer goods and services were available.



If goods were scarce in communist societies, then you might need to stand in line to wait until something became available. This condition inspired the well-worn phrase of workers in a communist economy: “We pretend to work, and they pretend to pay us.”

- ◆ And here’s the problem: With a low priority on consumer goods and services, there was rarely enough to buy—even if you had money to pay for goods or services. There was a continuous and general shortage. It also meant that what was available to the typical consumer in eastern Europe were goods and services behind the current styles and fashions of the West.
- ◆ Citizens who received approval to buy big-ticket items, such as cars or appliances, would first need to save the money required to pay the full price. In other words, because there were no consumer credit facilities or credit cards, cash was necessary to make the entire payment.
- ◆ But just having enough cash to buy a car didn’t mean that you could buy one. You had to be approved. The approval might come from your enterprise manager. This was one of the few tools the boss had available to motivate and reward better workers in a communist economy.
- ◆ Perhaps surprisingly, most families in Soviet bloc communist states had large amounts of cash. Economists often refer to this phenomenon as forced savings. Workers would accumulate cash as they were paid weekly. And if there wasn’t enough to buy, then they would just hold onto the cash. Sometime in the future, maybe there’d be something to buy.

- ◀ The problem of larger and larger amounts of cash in the hands of the population is known as monetary overhang. In market economies, an excess of cash usually leads to inflation. But one promise of the communist economic system was stable prices and no inflation. This promise was kept: Goods were cheap—at the cost of being unavailable.
- ◀ One problem that occurred in all former communist economies—right after the collapse of central planning economies and fixed prices—was an explosion in inflation and some periods of hyperinflation. It can be said that monetary overhang created conditions of repressed inflation.



Economists typically define hyperinflation as anything above 50 percent a year. In eastern Europe, most postcommunist inflation rates were initially in the thousands of percent.

- ◀ What was required to get rid of the inflation that came now was a complete monetary overhaul (and replacement) of the old money—with a new monetary standard and new money supply. This is what the immediate postwar West German government did by replacing the old reichsmark with the new deutsche mark. But many people lose most of their savings—and wealth—in such monetary transformations.

## Living Standards in Eastern Europe

- ◀ Aside from what eastern Europeans got to see on television and at the movies, the appearance of tourists from western Europe and the United States was another sign of the relative backwardness of living standards in eastern Europe. Ordinary citizens in East Berlin, Prague, Warsaw, and Budapest could see that their clothes, electronics, sporting goods, and luggage were all quite shabby compared to the possessions of ordinary tourists from the West.
- ◀ Although most leaders of eastern European communist parties, state offices, and big enterprises were all true believers in the promise of communism—and in the superiority of their system—to be confronted each day with their relative backwardness and second-class status compared with western Europe and the capitalist United States was extremely demoralizing.
- ◀ So, the only hold on power that the leaders of eastern Europe could count on was the presence of Soviet troops who enforced the Brezhnev Doctrine. And that started to change in 1985.
- ◀ The Brezhnev Doctrine was named for Leonid Brezhnev, the Soviet leader from 1964 to 1982. It stated that the Soviet Union and its allies had the right to intervene militarily in any eastern European communist country that was suspected of deviating from the Soviet model.
- ◀ The coming to power of Mikhail Gorbachev a few years later, in 1985, changed everything. Gorbachev needed to reform the Soviet economy to save it from collapsing. To do this, he needed to reduce the number of Soviet troops deployed in eastern

Europe and reduce the subsidies the Soviet Union was paying to its eastern European satellites. And he had to make them pay more for the Soviet oil sent to power their industries and electric grids.

- ◀ Oil prices crashed in the mid-1980s. In the Soviet Union, the bust in oil prices meant that right about when Gorbachev was coming to power, the state budget of the Soviet government had to be reduced, leaving less money to spend propping up the country and much less supporting eastern European satellite economies.
- ◀ Gorbachev began to tell his eastern European comrades that they were going to have to sink or swim on their own. They would need to reform their backward and stagnant economies themselves if they were to maintain their positions of power and authority.
- ◀ Unfortunately, the oligarchs were used to following Soviet orders, and the men in charge of eastern European countries in the mid- to late 1980s were creatures of the old system. Stephen Kotkin, a professor at Princeton University, described these men as “incompetent, blinkered, and ultimately bankrupt.” In other words, it wasn’t going to take much to topple them.
- ◀ The oligarchs’ minimal attempts at reform came to nothing. They tried to produce clothing and electronics for export to western Europe and North America, but these attempts essentially failed.
- ◀ Other economies in the world market were already making much cheaper and higher-quality goods. Notable among them were the rising economies of Asia, and new waves of consumer goods from Asia destroyed any hope that the market-ignorant oligarchs and enterprises in eastern Europe might have had.

- ◀ A final attempt to raise living standards by communist leaders in eastern Europe involved massive borrowings from the capitalist West. Eastern European leaders took out sovereign loans to buy Western consumer goods and technology for their economies.
- ◀ But they couldn't produce anything marketable to earn the hard currency needed to repay their loans, so they simply borrowed more. Eventually, they would default. Kotkin refers to this process as a Ponzi scheme.

## Communist Collapse

- ◀ On November 9, 1989, an East German Communist Party official named Gunther Schabowski made the mistake of stating during a press conference that East Berlin's border with West Berlin—the Berlin Wall—was now open, and citizens were free to travel to West Berlin and West Germany. The decision hadn't been taken formally by the communist leadership, but Berliners took matters into their own hands and headed for the wall.
- ◀ Soon after, the East German government collapsed, and citizens demanded unification and the freedoms of the West. In December 1989 and January 1990, in demonstrations throughout East Germany, protesters' signs and chants proclaimed, "*Wir sind ein Volk*" ("We are one people").
- ◀ The collapse of eastern Europe happened quickly and unexpectedly. But in hindsight, once Gorbachev pulled the plug, the leadership had nothing to support it. Most leaders decided that stepping down and saving their own skins was probably the wisest survival strategy.

- ◀ A key factor in the collapse of the former communist states with remarkably little violence or bloodshed was the restraint of Soviet troops under the direct control of Soviet General Secretary Mikhail Gorbachev. The outcome might have been much deadlier, as substantial numbers of Soviet troops remained deployed in East Germany, Poland, Hungary, and Czechoslovakia. The last of them would not leave until years later. But in the closing days of 1989, most Soviet soldiers deployed in Eastern Europe were under strict orders to stay in their barracks and not interfere in the domestic upheavals taking place in the streets.

### Readings

GEDMIN, *The Hidden Hand*.

KOTKIN, *Uncivil Society*.

SCHNEIDER, *The German Comedy*.

### Questions

- 1 Why were the chronic shortages of consumer goods and the complete absence of any inflation two sides of the same economic system coin?
- 2 Why was the presence of Mikhail Gorbachev as the leader of the Soviet Union and the ultimate commander of all Soviet troops the key factor in the peaceful revolutions in eastern Europe in 1989?



## Lecture 20

# From Chairman Mao to the Capitalist Roaders

**B**Y THE END OF THE FIRST MILLENNIUM, CHINA WAS the most economically developed area of the world. Yet by the middle of the second millennium, Europe surpassed China, which went into a centuries-long period of isolation and decline, followed by foreign conquest, occupation, and humiliation. This history of oppression by foreign powers plays a large part in contemporary Chinese economic, political, and military policy. Today, China is again a major economic power, but its reemergence took almost 1,000 years to accomplish. ♦

## Premodern Chinese History

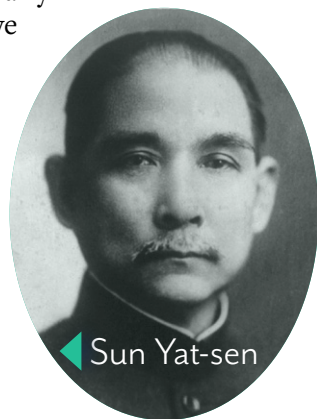
- Historically, Chinese emperors based their power and wealth on agriculture. China was a vast area populated by millions of peasants toiling on the lands of distant landlords. The income that these plantations produced fed the treasuries of the Chinese imperial class and their bureaucrats and servants.
- Because the peasants were so numerous—and the ruling class was so small—there was little pressure to increase agricultural output or think about technological improvements. Even illiterate peasants working with simple tools could produce more than enough food.
- The technical marvels of Chinese civilization—the water clocks and gunpowder—were considered interesting and entertaining toys. They were not considered marketable commodities capable of generating profits for further investments. The ruling class of China was bureaucratic and governmental, without the vision to create or expand markets.
- There was also little interest in the outside world and little or no desire to trade or exchange goods with foreigners. The Chinese rulers considered themselves a superior culture with nothing to gain from interacting with barbaric foreigners.
- The dominant religious or philosophical belief in imperial China was Confucianism, which taught deference to superiors and the maintenance of established social relations. It was hardly a philosophy to encourage innovation and entrepreneurship.
- For most of premodern Chinese history, there was an excess supply of labor and a shortage of arable land. This leads to low wages and high rents. Peasant laborers will stay poor,

and landlords will get rich. This is not a situation that fosters market demand for consumer goods or leads owners to search for labor-saving technology.

- ◆ By the middle of the 19<sup>th</sup> century, many Chinese got hooked on imported opium from British-ruled India. The so-called opium wars—resulting in new commercial privileges and legal and territorial concessions for Britain—became a further source of humiliation for the Chinese. Over time, the Chinese became less able to protect their citizens from the pushers of debilitating drugs, namely the British Empire.
- ◆ Further humiliation came in 1894, when the Japanese attacked China and seized the island of Formosa. This island was not returned to China until after World War II and then separated again after the communist revolution in 1949. It's known today as Taiwan, or the Republic of China.

## Chinese Leaders

- ◆ Two Chinese leaders emerged in the early 20<sup>th</sup> century who would attempt to drive out foreigners and modernize China. The first was Sun Yat-sen, leader of the Chinese Nationalist Party, who succeeded at establishing a new government in 1911 that drove out the last imperial rulers of the Qing dynasty, who had reigned since 1644. But Sun's government was not powerful enough to seize lasting power from the nation's landlord class, so political instability prevailed.



◆ Sun Yat-sen

- ◀ Then came Mao Zedong, who helped found the Chinese Communist Party in 1921. Impressed with Marxist theory and the Russian Revolution, Mao saw the same revolutionary potential in China's peasant class. He was invited to Moscow by the new Soviet government and given education and training in communist theory and tactics.
- ◀ Sun Yat-sen died in 1925 and was succeeded by the anti-communist soldier and nationalist Chiang Kai-shek. A civil war broke out between the forces of Mao and those of Chiang Kai-shek. The Nationalists scored several victories over the communists, who were forced to retreat to a mountain stronghold in northwest China. This "Long March" by Mao's forces was turned into one of the foundation myths of the Chinese Communist Party.
- ◀ The Japanese invaded again in 1931, seizing the province of Manchuria and occupying several coastal cities of China. Japanese soldiers engaged in mass executions and rape that are today considered one of the more horrific crimes against humanity during the 20<sup>th</sup> century.
- ◀ After the Japanese invaded Manchuria, Mao and Chiang Kai-shek agreed to a temporary truce while they fought to drive out the Japanese. During this period, about 20 million Chinese lost their lives in the fight against the Japanese.
- ◀ Later, when World War II ended and the Japanese were defeated, hostilities broke out again between Mao's communist forces and the Nationalist army led by Chiang Kai-shek. By this time, Mao had secured the backing of most of the Chinese peasantry. He did so by promising land redistribution from the landlords to the peasants. And because the peasantry was the dominant class in Chinese society, Mao had the majority of the population on his side.

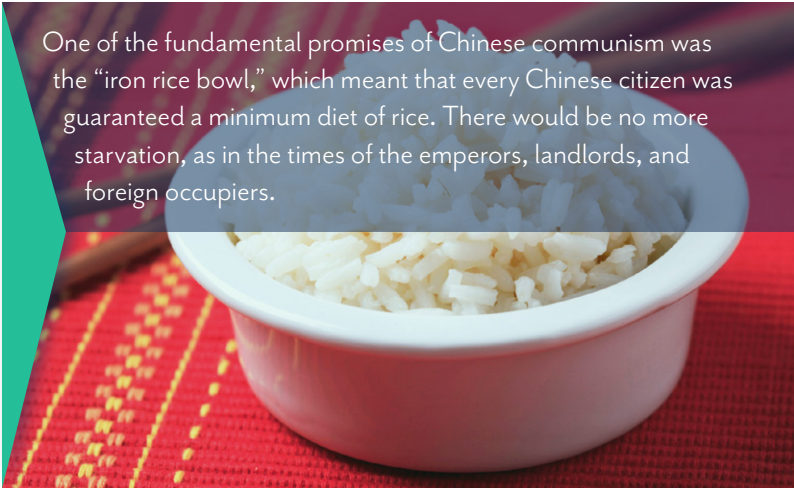
- ◀ Mao defeated the forces of Chiang Kai-shek in 1949, and Chiang fled with the Nationalist forces to the island of Formosa. After the People's Republic of China was founded in October 1949, Mao initially kept his promise and redistributed land to more than 300 million peasants. While this was politically popular, it was economically damaging. The peasants' plots were very small—suitable only for small-scale production with simple tools and unskilled labor.
- ◀ One key concept in economics is the idea of economies of scale. To achieve efficiencies and lower costs of production, output should be above a certain level. If output is too small, then labor-saving machinery and efficiencies of large-scale production are not possible.
- ◀ Peasants have little interest in improving productivity because they're mainly interested in feeding themselves and their families. The Chinese communists were not big on markets and producing for profits. And the peasants didn't have much of an incentive to expand production beyond their own needs.

## From Agriculture to Industry

- ◀ One key force in any country's transition from an agricultural to an industrial economy is an increase in agricultural productivity. Increases in agricultural output make industrialization possible in several ways:
  - 1 Agricultural output is the input for industry. For example, for a food industry to develop, farmers need to produce wheat for bakeries.

- 2 As farms become more productive and need less labor, the excess labor can move to the cities to become workers in industry. Societies modernize by moving people off the farm and into the cities.
  - 3 Farmers must produce enough food not only to feed themselves but also a growing urban and industrial labor force.
- ◀ The small plots created by Mao's land-redistribution program for China's peasants did not permit or create the incentives for increased output. And without increased output, the country would find it next to impossible to industrialize.
  - ◀ But industrialization is what Mao wanted for his country. Mao's initial ideas about industrialization came from the leadership of the Soviet Union. In 1953, Mao introduced the first five-year plan for China. It was a faithful copy of the Soviet approach to economic development and contained all the basic components of the initial Soviet five-year plans, including the nationalization of all large enterprises and elimination of most private property.
  - ◀ The process of constructing a national, comprehensive economic plan for a country as large as China was extremely difficult. The key problem that Mao and the economic planners faced was low productivity in Chinese agriculture. China during the 1950s was almost entirely rural and agricultural, so it was incumbent on the Chinese planners to raise agricultural productivity.
  - ◀ But most Chinese farms were too small. Land redistribution had created hundreds of millions of very small farms. These plots were too small to use even basic farm machinery. They were also unsuited to take advantage of fertilizers, as peasant farmers were used to using the manure produced by farm animals as their primary fertilizer.

- ◀ Again following the Soviets, Mao initiated a process of collectivization to force farmers into large cooperative or state-owned farms. These collectives were required to sell most of their output to state agencies at very low prices. The state agencies, mostly under the direction of the ministry of agriculture, would then sell the farm products at considerably higher retail prices. This price differential was one of the key sources of finance that the state could use to purchase machinery and begin the process of industrialization.
- ◀ The collective farms were theoretically owned by all of the farm workers. They would share whatever income was earned by the sale of their products to the state procurement agencies. Their share of the income would be determined by their hours of work and level of skill of the work they did. In theory, this would be determined by the votes of the collective farmers. But in fact, all key decisions of the collective farm were determined by the farm manager, who was appointed by the central ministry of agriculture.



One of the fundamental promises of Chinese communism was the “iron rice bowl,” which meant that every Chinese citizen was guaranteed a minimum diet of rice. There would be no more starvation, as in the times of the emperors, landlords, and foreign occupiers.

- ◀ State farms were somewhat different in that they were organized to resemble factories in cities. Farmers were treated as laborers and paid an hourly wage. Typically, state farms tended to be much larger than collective farms and produced more important products for the planned economy.
- ◀ Even so, the farm workers on the collectives and state farms earned meager incomes and would have had a hard time feeding themselves and their families if it wasn't for the tiny plots of land where they were allowed to grow their own food.
- ◀ For most Chinese farmers, the family plot was their chief source of food. They were also able, at times, to sell a small amount of their surplus produce in local markets. This gave them money to buy clothes or simple household items, if those items were available.

## Mao's Decline

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- ◀ At the end of the first five-year plan in 1958, Mao was disillusioned with the results. The growth of Chinese industry was slow and did not replicate the rapid industrial development that the Soviet Union had achieved in the 1930s. So, Mao decided to break with the Soviet Union model.
- ◀ Instead, he launched what became known as the Great Leap Forward. As part of this, all Chinese, including farmers and rural inhabitants, would participate in the drive to rapidly industrialize the Chinese economy. Mao ordered the creation of much larger collective farms that would each consist of at least 5,000 households. These large collective enterprises would also build “backyard factories” that would produce iron, steel, and cement in the countryside.

- ◀ The Great Leap Forward caused agricultural production to decline, and much of the output of the backyard factories was unusable. The decline in agricultural production led to widespread famine. The death estimates caused by such privation range as high as 20 million Chinese.
- ◀ The catastrophic failure of Mao's Great Leap Forward caused him a great loss of prestige and criticism inside the leadership of the Chinese Communist Party. To protect his leadership position—and to fight his enemies within the Chinese Communist Party—Mao launched the Great Proletarian Cultural Revolution of 1966.



During the Great Proletarian Cultural Revolution of 1966, elite knowledge, science, philosophy, and literature were all denigrated in China. All that was needed was a knowledge of Mao Zedong's thought, found in a little red book that contained Mao's most important sayings.

- ◀ Many Chinese people suffered from the Cultural Revolution. Writers, scientists, intellectuals, teachers—anyone who used their brains in their work—were likely to suffer persecution and worse. The effect of the Cultural Revolution on the Chinese economy was disastrous. Economic output fell steadily from 1966 to 1970. Significant Chinese resources of human capital and brainpower were wasted and destroyed.
- ◀ From Mao's perspective, the Cultural Revolution was a success. It sidelined—or eliminated—most of his opposition within the leadership of the Chinese Communist Party. He was able to maintain his position with no more significant challenges until his death in 1976. But the cost to the Chinese of Mao's bureaucratic victory was a decade of lost potential and reduced standards of living.

At the time of Mao's death, most Chinese did not live significantly better than they had at the time of the revolution in 1949.



- ◀ Immediately after Mao's passing, a new leadership struggle broke out in the top ranks of the Chinese Communist Party. There were two basic factions. One side contained those who wanted to continue Mao's policies. This faction included Mao's widow, Jian Qing—the Madame—and was labeled the Gang of Four.

- ◀ However, the victorious faction, led by Deng Xiaoping, advocated significant reforms in the Chinese economy. These reforms included using material incentives to encourage productive work, permitting some private ownership and decision making, an openness to foreign trade and investment, and a decentralization of decision making with much less emphasis on central planning.
- ◀ Madame Mao's faction labeled Deng's movement the capitalist roaders, combining the notion of going down the wrong road with the idea that capitalism is evil. But the reforms that Deng introduced, starting in 1979, would have profound consequences for China, the United States, and the rest of the world.

### Readings

SNOW, *Red Star over China*.

WALDER, *China under Mao*.

### Questions

- 1 What historical and economic forces led a large part of the Chinese population to support the revolution led by Mao Zedong in 1949?
- 2 Why did Mao abandon the Soviet model of an economic system? What did he put in its place, and what were the consequences of his change?



## *Lecture 21*

# After Deng, China Privatizes and Globalizes

**C**HINA HAS MADE ONE OF THE MOST DRAMATIC transitions in history—from a poor, rural society to a modern global economy with a predominantly urban population and a large middle class. How did China make such a miraculous transformation in only a few decades? And how has this transformation affected the rest of the world, especially the United States? The answers can be found by going back to the time right after the death of Mao Zedong in 1976, when the leadership of China's Communist Party made major changes. Deng Xiaoping marginalized and then ousted Mao's designated successor, Hua Guofeng, from party leadership. Now, the country would privatize, decentralize, and globalize. ♦

## Transition Reforms: China versus Russia

- From such modest beginnings, China's economic reforms under Deng Xiaoping have turned out much more successful and beneficial to his country than the transition reforms that Mikhail Gorbachev introduced to the former Soviet Union, beginning in the mid-1980s.
- There are several reasons why China's transition has been more of a success than Russia's. One key Soviet reform under Gorbachev was the policy of glasnost, which means "openness" in Russian. While a great advance for democracy and cultural freedom, this unleashed waves of discontent and chaos.
- Soon after Gorbachev's opening of political dissent, the Soviet Union plunged into a period of no control or direction. All sectors of society began to connive and steal for their own benefit, with the strongest and best-connected individuals coming out on top.
- In contrast, the Chinese Communist Party has never allowed completely free political or cultural freedom and dissent. They have been much more authoritarian and dictatorial than Gorbachev was. In fact, the former Soviet Union's example of chaos and ultimate collapse was an object lesson for the leadership of the Chinese Communist Party. Their major fear became experiencing a Soviet-style collapse and the loss of power.



- ◀ What makes this study in contrasts all the more remarkable is that China was a much poorer economy in 1978 than the Soviet Union's was in 1985, when Gorbachev began his reforms. The Chinese were much more rural and agricultural. There was not a large industrial sector created and organized on the Soviet model. So, the Chinese didn't have to dismantle and reorganize a large industrial economic system, as the Russians had to do.
- ◀ Also, China had been a communist economic system for fewer than 30 years when Deng began his reforms. In comparison, Russia had been a communist economy for 68 years when Gorbachev came to power. So, in China, there was less to undo and unlearn.
- ◀ Then, in undertaking reform, China was blessed with much greater access to foreign financial capital and human capital. The former crown colony of Hong Kong is among the world's leading financial centers, and the Chinese diaspora in Hong Kong, Taiwan, and the rest of Asia was available—and usually willing—to provide expertise, advice, and management. There's also a large, interconnected Chinese population in Canada and the United States.
- ◀ The availability of such invaluable knowledge and human capital, even abroad, has been a tremendous boost to the economic transformation of mainland China. Russia had no equivalent diaspora. It was never a capitalist country. And few Russian expatriates were successful enough, on an international level, to effectively advise Gorbachev or the post-Soviet governments.
- ◀ China—directed by its authoritarian leadership, funded by deep wells of financial capital, and guided by a network of entrepreneurs, both onshore and off—has also understood the benefits of gradual change. Its planners introduced reform measures one at a time.

- ◀ Often, such reforms were instituted locally and regionally first, rather than throughout the entire country. This way, if the reforms were unsuccessful, they didn't damage the national economy. The gradualist approach was different than advocated by Western “experts” advising the post-Soviet government of President Boris Yeltsin.
- ◀ These experts were mostly from the United States, and they advocated rapid privatization, the complete freeing of prices, and the dismantling of all economic planning. This neoliberal advice was based on the Washington Consensus, which maintained that what countries needed to grow their economies was to free prices, privatize as much as possible, and reduce the government's role in the economy.
- ◀ The fact that this consensus had not been followed by the rich countries of the world and that there was little evidence that the policies had actually worked anywhere didn't deter legions of economists flocking to Moscow from Washington and many prominent American universities and think tanks. They proclaimed their unproven formulas with almost religious zeal.

## Deng-Era Reforms

- ◀ Chinese reforms began with the comprehensive overhaul of the country's agricultural system and the encouragement of individual Chinese farmers to become economically successful. This was carried out by reducing the number of collective farms and giving individual growers the opportunity to lease land for their own use.

- ◀ Such leases included an obligation that the farmers sell half of their crop to the state at fixed prices. But they could sell the remainder on private markets at higher prices and keep the income from both types of sales. In this manner, the state created incentives for greater production while also maintaining some control of farm output, including food for urban residents and inputs for manufacturing.
- ◀ The terms of such farm leases could be as long as 30 years. This gave the farmers a stake in maintaining the quality of the land and an incentive to improve productivity through better seeds, fertilizer, and mechanization. Furthermore, the farmers could



Today, only about 20 percent of China's farm output is sold to the state and 80 percent is sold on private markets. But the state remains actively engaged in the agricultural sector, in part by providing equipment leases to its farmers and subsidies for their infrastructure.

sell the lease rights to other farmers. Although the state still owned the land, this went about as far toward a private-property system in agriculture that any socialist economy has gone to date.

- ◀ In China, a mixture of private incentives and government support has led to significant increases in farm productivity and has allowed many rural residents to move from countryside to city. This movement was necessary to support the leadership's industrialization and trade policies.
- ◀ In turn, reform in the manufacturing sector started with local authorities being given the power to start up small enterprises and retain the income to support local needs. If these local manufacturing enterprises were successful, then the local authorities would have more income to support their schools, hospitals, roads, and other municipal needs.
- ◀ At the beginning of the Deng Xiaoping-era reforms, most private enterprises were either restaurants or small retail stores. Eventually, Deng's reforms allowed centrally planned large enterprises to become independently run. They were still owned by the state, but the state-owned enterprises (SOEs) were expected to perform like market-driven corporations, albeit frequently in state-protected economic sectors and with some big consequences for American businesses and markets.
- ◀ China's SOEs became prominent in large-scale manufacturing, transportation, and natural resources as well as in steel production, mining, and petroleum refining.
- ◀ Although Chinese SOEs share some characteristics of large capitalist corporations, there are also some very big differences. For example, because the Chinese government is the principal owner, the government can decide on the SOE's operating objectives.

- ◀ Like other enterprises in a planned economy, the SOEs might be given output targets, delivered to state bureaucracies or other SOEs. And because the primary objective of the SOE is output, management has an inherent incentive to understate its productive capacity and to overstate its demand for resources.
- ◀ This was also typical behavior for an enterprise in the Soviet Union. By having output as the main objective, one by-product is maximizing employment. Maximizing output and employment are two sides of the same coin.
- ◀ SOEs enjoyed what the Hungarian economist János Kornai calls a soft budget constraint. This is different than the hard budget constraint faced by a typical capitalist corporation.
- ◀ If a capitalist corporation doesn't make profits, sooner or later its bankers or stockholders will force changes, or the enterprise will go bankrupt. If the corporation gets most of its operating funds from a bank, the bank will cut off credit. If the corporation gets most of its financial capital from investors, they will balk, and management will be forced to cut expenses, often by laying off employees or selling parts of the business. If this doesn't stem losses, the company will fail.
- ◀ An SOE might not face any hard budget constraint from its state sponsor. Often, the SOE is the major employer in a particular town or region. Shutting down the SOE would mean that the town will suffer both in terms of unemployment and reduction in tax revenues. But government subsidies can make up for temporary losses. The management of the SOE knows this and therefore might be tempted to expand production and employment beyond purely economic limits.

- ◀ Compared to purely private enterprises, SOEs are less efficient and a drain on the central government's budget. However, employment in a communist system is very much a political issue that is central to the state's stability and survival. That's why they are a continual problem for sponsoring governments. In a capitalist system, by comparison, if a company goes bankrupt—and employees lose their jobs—this is often understood as a consequence of market competition.
- ◀ The U.S. government sometimes does bail out money-losing firms because they are too big and too important. But in China, when an SOE shuts down or lays off workers, this is understood as a government decision. The people believe that the government is responsible. And the Chinese government, led by the Communist Party, relies on the support of the population for its hold on power.
- ◀ Another key example of the Deng Xiaoping-era reforms was the introduction of special economic zones (SEZs), which allowed foreign businesses to operate joint ventures with Chinese enterprises. The objective was to get the benefits of foreign financial investment, foreign technology, and access to foreign markets. The SEZs offered foreign investors low taxes, low utility rates, low rents, and the ability to export. Soon, their output began showing up in American retail stores.

China's first special economic zones were located mostly in the south and along the east coast of the country so that they would be close to financial centers and international ports of Hong Kong and Shanghai and to the Chinese diaspora working in Indonesia, Singapore, and Taiwan, as well as in Hong Kong.

- ◀ Even though China's SEZs were limited and controlled by the Chinese government, the benefits to China of allowing foreigners to produce and do business in the country were quite large. Economists talk about "external economies" arising from the operations of businesses in a particular area. These external economies include knowledge spillover effects, where local businesspeople and workers learn new ways of organizing work as well as the existence of foreign markets and gain access to new technology.

## Chinese Exports to the United States

- ◀ The Chinese pattern of exports and imports followed the classic principles of comparative advantage laid out by the British political economist David Ricardo during the 1800s.



The first wave of Chinese exports to America was clothes and shoes. Nearly every industrializing country starts their path toward industrialization with textiles.

- ◀ In the beginning, China had a large supply of unskilled labor and, therefore, a comparative advantage in products that would employ unskilled workers, such as T-shirts and flip-flops. China did not have a comparative advantage in complex products requiring highly skilled workers, so they imported Boeing 747s, for example.
- ◀ Still, the growth of Chinese exports to the United States was spectacular. From 1991 to 2007, Chinese exports to America rose nearly 13-fold, from 26 billion dollars to 330 billion dollars.
- ◀ The effects of Chinese exports to the United States are controversial, and much debated by economists. The benefits are pretty clear: Americans gain access to much less expensive goods, and this raises their standard of living, especially among low-income Americans who can afford only cheaper goods.
- ◀ The costs are not so clear, but there have been serious attempts to measure them. MIT economist David Autor has written several articles and papers on the effects of Chinese imports on American workers and regions. He estimates that about half of the decline in American manufacturing employment is due to Chinese imports.
- ◀ Imports from China are produced by unskilled labor, and this reduces the demand for American products produced by competing labor. Furthermore, declines in employment increase the need for unemployment benefits, disability, and other government transfer payments. This leads to pressure on public-sector budgets and increases the likelihood of government budget deficits.
- ◀ Autor attributes the Deng-inspired rise in Chinese exports to the United States to its investments in labor-intensive industries and rising productivity, as well as developments in transportation.

- ◀ Unfortunately, there's no simple answer that the United States can apply to the resulting problems in its own economy. The simple solution might be to block all imports from China. But if we stopped all imports from China, production of most goods that come from there would unlikely come back to the United States; instead, they would likely move to Indonesia, Vietnam, or some other developing country.

### Readings

AUTOR, DORN, AND HANSON, "The China Syndrome."

CHOW, *China's Economic Transformation*.

### Questions

- 1 The reforms of Deng Xiaoping were a dramatic break from the standard communist economic system. What was the first key change that Deng instituted in the Chinese economy, and why was this so important?
- 2 How did China go from a completely isolated economy to a major player in the global economy? What were the consequences of this change for the U.S. economy?



## *Lecture 22*

# Asian Tigers: Wealth and State Control

**S**OUTH KOREA, TAIWAN, AND SINGAPORE MADE remarkable transformations from poor countries to high-income economies between 1950 and 2000. Their economic progress is unprecedented in history. At first, they were referred to as newly industrialized countries, and then—along with Hong Kong—as the Asian Tigers. What were the secrets of their miraculous growth? And can other countries copy them? This lecture will uncover some of their secrets and critique their strategies. ♦

## Common Approaches to Economic Growth

- ◆ The approaches to economic growth of South Korea, Taiwan, and Singapore have many similarities. The island of Formosa, or Taiwan, became dominated by the former Kuomintang government of mainland China in about 1947 and has operated autonomously ever since, though the United Nations has recognized communist China as its rightful government since 1971.
- ◆ South Korea gained its independence from Japan after colonial rule ended there in 1945. And Singapore gained its independence from Great Britain in 1959. All three were led by authoritarian, one-party governments. Korea and Taiwan were under martial law for almost 20 years. So, the question can be asked as to whether a developing country needs to be led by a forceful hand through the difficult process of building an economy.
- ◆ At first blush, the example of the three Asian Tigers suggests that autocratic rule can be a successful approach—if the authoritarian leader is truly focused on developing the country and making wise decisions that benefit its citizens in the long run.
- ◆ But authoritarian rule by a single strongman does not guarantee economic success. So, it might be that South Korea, Singapore, and Taiwan were fortunate in their choice of dictators: Park Chung Hee, Lee Kuan Yew, and Chiang Kai-shek, respectively. Whether or not they would be as successful in more democratic societies is open to question.
- ◆ One key aspect of the development strategies in all three countries was an emphasis on education and the formation of human capital. Economists use the concept of human capital to cover all aspects of education and training. A significant part of human capital is primary and secondary education.

Singapore is so successful at promoting primary and secondary education that it ranked first in the world in a recent ranking of 15-year-old students by the Organization for Economic Cooperation and Development. South Korea and Taiwan also typically score very well—higher than the United States, for example—though the triennial rankings do shift a bit.



- ◀ Another part is the development of skills and experience necessary for rapid industrialization. In practice, skills and experience means an emphasis on math and science in primary and secondary schools and engineering in higher education.
- ◀ Along with a heavy emphasis on education, all three Tigers also employed some type of formal state-level economic planning and emphasis to identify priority sectors of economic development. The planning was not dictatorial, Soviet style, but more like France's system of indicative planning, which relies on incentives and economic support rather than fiat.

- ◀ The Tigers also all relied on some form of state ownership for key enterprises and other enterprises that might not be profitable if operated as strictly private capitalist firms. All three Tiger countries used tariffs (taxes on imported goods that make foreign products more expensive than domestic ones) and quotas (a numerical limit on the quantity of imports that can be brought into a country) to protect favored infant industries—that is, economic sectors and enterprises in the early stage of development.
- ◀ South Korea, Singapore, and Taiwan placed tariffs and quotas alike on imports of manufactured goods that might compete with favored domestic manufacturers. Because the favored domestic manufacturers of Korea, Taiwan, and Singapore were relatively new at the time, they were infant industries in the world trade in manufactured goods.
- ◀ There are significant problems with the infant-industry argument for high tariff and quota protection. One of them is identifying which industries are truly infant and deserving of protection. Every business wants protection from foreign competition. And once infant industry protection is introduced, it might be very difficult to remove.
- ◀ The Asian Tigers had to be judicious in picking the particular sectors to be protected from foreign competition. The Tigers' protections were geared to developing export industries—and participating in the global economic system—rather than to help their domestic consumers. Although the governments specifically protected some industries, they were also willing to develop all domestic industries that they believed could compete in world markets.
- ◀ The Tigers also were keen on taking advantage of foreign investment to finance national development. Foreign investment would bring in needed capital, but most importantly, it would bring in know-how and advanced technology.

- ◀ Newly industrializing countries—by observing and learning the methods of more advanced foreign enterprises—could reap the spillover effects of knowledge. Workers in a foreign enterprise would develop skills and experience that they could transfer to their domestic enterprises.
- ◀ Some production in the Tiger countries was state-owned, but most was in private hands. And these businesses were not *commanded* to produce certain products, as would have been the case in the former Soviet Union or the communist economies of eastern Europe. But they were *encouraged* to follow central government preferences, through a variety of means.
- ◀ These means included concessionary loans and interest rates to support the state's high-priority industrial investments. And because the governments of the Tigers owned or controlled the banking system, the direction and terms of business loans was an instrument of state control.
- ◀ Business firms that did not produce products explicitly favored by the government might face higher interest rates, if they could borrow money—and they might not have access to credit at all. Being denied access to loans for financing current operations or for expansion plans is not necessarily a dictatorial command, but it comes pretty close to government directive.
- ◀ Tax policy is another avenue of indicative planning, and it is used in all market economies, including in the United States. For a country focused on rapid economic

No high-income country has ever developed its own advanced technology at the beginning of its industrialization process. For example, the United States adopted British railroad technology.

development, tax policy is directed at enterprises that the state considers key to the industrialization process. Tax policy might consist of lower tax rates on profits or higher deductions on capital expenditures.

- ◀ Lower tax rates provide favored enterprises with more retained earnings and, hence, more funds for expansion. Higher deductions for capital or equipment expenditures accomplish the same thing, in a different way. Expenses authorized to be treated as deductions can be more directly targeted by government planners than rates themselves. Either way, greater retained earnings leave more funds for the enterprise to spend on investment.
- ◀ Governments in the Tiger countries usually owned the power and water utilities. The state could, therefore, charge high-priority enterprises advantageous prices for power and water. Additionally, if the state owned key input enterprises—a steel producer, for example—the state could supply these key inputs to favored enterprises, again at lower prices.
- ◀ Finally, all three governments maintained controls on foreign-exchange transactions during their development. Domestic access to foreign exchange was usually limited to purchases of needed foreign technology or other inputs not available locally. Foreign exchange earned from exporting domestic products was used wisely to purchase foreign machinery and key inputs in the industrialization process.
- ◀ One advantage that the three Tigers had was what the late-19<sup>th</sup>-century and early-20<sup>th</sup>-century Norwegian American economist Thorstein Veblen called the advantage of backwardness. When you are behind in technology and industrial development, you don't have to discover or innovate. You just have to be sure to adopt the best practices. You can take advantage of someone else's genius and leap forward in the development process.

## South Korea

- At the end of the Korean War in July 1953, the Republic of Korea—South Korea—was a backward country, even compared to North Korea, or the Democratic People's Republic of Korea. It had a lower gross domestic product and a less industrial economy than the north did, mainly as a legacy of Japanese colonialism.
- Imperial Japan had envisioned the northern part of the peninsular protectorate as an industrial supplier to another Japanese colony in Manchuria, in northeastern China. The northern part of Korea was relatively closer to Manchuria, and for this reason it was more industrially developed than the agricultural south.
- The partition of the Korean peninsula into the communist north and the market-oriented south was formalized as part of an armistice agreement ending the war in July 1953. A few years after the formal partition, an enterprising South Korean general named Park Chung Hee staged a coup that overthrew the unstable and short-lived parliamentary Second Republic.
- In 1961, he took over control of a country with a per capita gross domestic product of about 82 dollars. About 50 years later, South Korea's per capita gross domestic product had grown more than 400-fold to in excess of 34,000 dollars. By comparison, it took the United States 150 years to industrialize to a similar level. Some of the rapidity of the South Korean advance can be attributed to the “catching-up” effect of a backward country emulating the best practices of technological leaders.
- How did the South Korean economy accomplish this miracle? The answer lies in a focused and rigorous economic effort. This effort was channeled by a wise government into forcing an agrarian, underdeveloped economy to save and invest for future growth.

- ◀ Resources were to be channeled into specific industries: steel, shipbuilding, electronics, chemicals, and automobiles. Most production in these priority industries was carried out by privately owned enterprises rather than by the state directly. In turn, these domestic enterprises were grouped into industrial conglomerates called chaebols, typically by a founding family. These chaebols are still the backbone of the Korean economy. Among the most important chaebols are Samsung and Hyundai.
- ◀ South Korea also had a somewhat laissez-faire attitude toward other people's intellectual property at the beginning. Knock-off shoes and purses, bootleg tapes and movies, and noncopyrighted books were all permitted—chiefly as a way to minimize the use of foreign exchange for import goods.

## Taiwan

- ◀ After the communist Chinese revolutionary Mao Zedong achieved victory against Chiang Kai-shek's Nationalists in a long-running civil war that culminated in 1949, Chiang and his Kuomintang party fled across the Formosa Strait to the island of Taiwan, where they established what Chiang called the Republic of China.
- ◀ One of Chiang's first economic policies in the new island state was massive land reform: taking property away from holders and redistributing it to individual farmers. The Kuomintang's intent was to redistribute the holdings of former Japanese landlords who had occupied Taiwan until the end of World War II.
- ◀ Taking land from oppressive Japanese created little or no domestic opposition and created much good will. Also, because Chiang Kai-shek and the Kuomintang were predominantly

mainland Chinese, they were not expropriating property from any of the new government's immediate supporters and allies.

- ▶ Taiwan's land-reform program accomplished many things crucial to economic development. It increased agricultural production. In turn, this provided more food for urban workers and raw materials for new factories. And by making agriculture more productive, fewer workers were needed on Taiwan's farms. Some could move to the cities to be urban factory workers.
- ▶ To support and facilitate the new farmers getting money for needed equipment, seeds, and fertilizer, the Chiang government created the Land Bank of Taiwan, a state-owned entity that provided low-cost loans to farmers. Because it was state-owned, the land bank did not need to worry about making immediate profits and could take a much longer view. Loans from the United States government were another key element in Taiwan's early development.

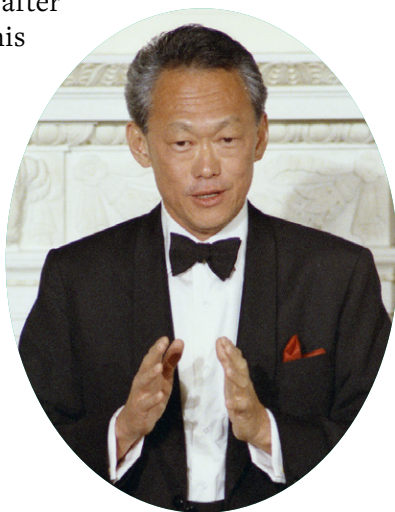


Chiang's land-reform efforts were so successful—and such an important element of Taiwan's development—that the national government created a Land Reform Museum in Taipei in 1967.

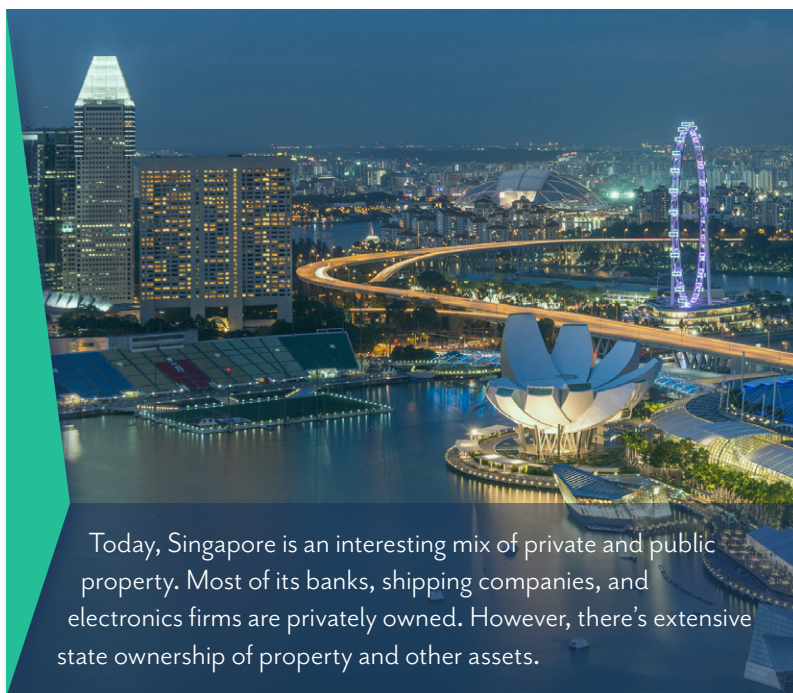
- ◀ In Taiwan, the Chiang government chose to prioritize a domestic electronics industry. To jump-start the sector, it created a state-owned enterprise known as the Taiwan Semiconductor Manufacturing Company, which developed technology and components for some of Taiwan's newly emerging private companies.
- ◀ Taiwan also established and funded science and industrial parks in several of its larger cities. Most business activity in these parks is devoted to research related to information technology and biotechnology—leading sectors in contemporary high-income economies.

## Singapore

- ◀ Lee Kuan Yew, Singapore's leader after independence, was adamant in his drive to educate fellow citizens. Early in his administration, Lee Kuan Yew invited select Western technology companies to Singapore to instruct his countrymen on the organizations' best practices. Among the companies who came—and became eligible for special treatment on taxes, profits, and property—were Texas Instruments, General Electric, and Hewlett-Packard.



- ◀ Singapore also developed expertise in shipping and logistics. The former British Royal Naval base there provided basic infrastructure for what was about to become the age of container shipping. In addition, foreign bankers were invited to set up subsidiaries in Singapore; these arrivals formed the nucleus of one of the major banking and financial centers of Asia. And the British colonial legacy of the English language—the language of international finance—was invaluable.
- ◀ Lee Kuan Yew was obsessed with creating a strong and independent Singapore so that it would never again suffer the humiliations of colonialism.



Today, Singapore is an interesting mix of private and public property. Most of its banks, shipping companies, and electronics firms are privately owned. However, there's extensive state ownership of property and other assets.

## Readings

CHANG, *Bad Samaritans*.

CHANG AND GRABEL, *Reclaiming Development*.

## Questions

- 1 What were the advantages to the Asian Tiger economies of having a strongman in charge of development? What were the goals of these strongmen?
- 2 Are the stories about the economic miracles in South Korea, Singapore, and Taiwan stories about the wonders of the free enterprise system?



## *Lecture 23*

# European Union: Success or Failure?

**T**HE EUROPEAN UNION (EU) HAS BEEN BOTH A GREAT success and a disappointing failure. Established by a succession of treaties beginning in 1951, the EU has been spectacularly successful in its primary mission: the prevention of war among the major European powers. Yet another success of the EU has been the peaceful and largely successful transformation of former dictatorships and former communist states to modern democracies. The failures of the EU include its inability to sustain increasing incomes and opportunity for everyone. Several regions and pockets of Europe have suffered disproportionately from the forces of globalization and from increased international competition. ♦

## The Creation of the European Union

- ◀ The European Union owes much of its foundation to the United States, and especially the post–World War II economic policies of the Truman administration. But some of the solutions Europe introduced during and after World War II are a direct result of earlier, failed policy prescriptions.
- ◀ Specifically, after World War I, the victorious French and British governments insisted that the Allied powers should impose heavy reparation burdens on the defeated Axis economies—especially Germany. The French and British also imposed high tariffs on the imports from other countries, and they set the values of their currencies too high relative to the price of gold and thus made their exports too expensive.



Since World War II, there has been peace among the European powers, and sustained growth and prosperity have brought most Europeans unprecedented levels of well-being. The European Union can be thanked for this.

- ◀ After World War II, the U.S. government took a much more active and enlightened approach to postwar policy in Europe than its European allies had previously. Congress and the administration created a project called the European Recovery Program, or Marshall Plan, which offered U.S. taxpayer funds to all combatant countries in Europe, winners and losers alike. And the recipient countries were required to create a common organization to administer these funds. This umbrella body became the Organisation of European Economic Co-operation.
- ◀ With the help mainly of the British, especially the economist John Maynard Keynes—a key advisor to Winston Churchill—the United States also led the way in establishing the International Monetary Fund (IMF), which became a vehicle for establishing a system of fixed exchange rates among all the major currencies of western Europe, North America, and Japan.
- ◀ In turn, this cooperative currency arrangement was a precursor of EU monetary unification years later, in 1999. Among other early advantages, the postwar system of fixed exchange rates prevented countries from practicing competitive devaluations of their currencies.
- ◀ Competitive devaluations were an especially harmful practice during the Great Depression years of the 1930s. Countries would drive down the value of their own currency in a bid to increase exports and decrease imports. But this practice works only if just one country is devaluing.
- ◀ In practice, if one country tries to gain an advantage by depreciating its currency, then other countries might do the same out of self-defense. This results in chaos and the breakdown of international trade and finance. It illustrates a principle known as the fallacy of composition—the false belief that if something is good for one actor, it will be beneficial for all actors.

- ◀ Another postwar economic accord with significant lasting effects was the 1947 General Agreement on Tariffs and Trade (GATT), which fostered lower trade barriers and the freer flow of goods among participating countries. It was yet another proposed solution to failed policy prescriptions of the past—specifically, the imposition of high tariffs by one country to decrease imports from other countries, supposedly to protect domestic businesses and workers. Again, this works only if just one country takes the peremptory action. But other countries almost always follow. If they didn't, their own businesses and workers would be at risk.
- ◀ For better or worse, each of the postwar policy prescriptions and institutions, including the IMF and GATT, were designed to make market-based economies work better. While social democratic politicians—that is, those who seek to promote social justice within a capitalist framework—were involved in the creation of the EU, it was nevertheless intentionally designed to make private businesses more stable, efficient, and dynamic.
- ◀ The EU was erected through a series of treaties that led to greater and greater degrees of economic integration. As economies become closer, their populations trade more with one another and they invest in each other's economy, allow (or insist on) businesses and workers moving between the countries, and tend to reduce trade barriers.

## Stages of Economic Integration


- ◀ The process of economic integration can be modeled in four stages, as was first described by the Canadian economist Jacob Viner, who viewed these four stages through increasing levels of economic integration: a free-trade area, a customs union, a formal common market, and an economic and monetary union.

- 1 The first stage is a free-trade area. This reflects an agreement between two or more countries to remove trade barriers between their economies. That limited framework of cooperation notwithstanding, no common tariffs or quotas apply to countries outside of the free-trade agreement.
- 2 The second stage is a customs union. It adds a common external tariff and quota policy. In Europe, the 1958 Treaty of Rome established a customs union among the original six-member states of the European Economic Community (EEC): West Germany, France, Italy, Belgium, the Netherlands, and Luxembourg. In 1973, the EEC added the United Kingdom, the Republic of Ireland, and Denmark. Greece was admitted to the EEC in 1981, and Portugal and Spain were admitted in 1986.

The European integration movement has always mandated that members be democratic states, so in the 1970s, Spain, Portugal, and Greece were not eligible for membership in the European Economic Community. All three countries joined in the 1980s, making the promotion of democracy another success of the European unification project.



- 3 The third stage is a formal common market, which includes not only the free movement of goods among member states but also the free movement of labor, capital, and services. In Europe, this stage was created in 1986 by the Single European Act, which was designed to increase competition, promote efficiency, and establish a bigger market. Under this act, new sources of workers within the EU could seek employment in the United Kingdom from Poland, Romania, Bulgaria, and elsewhere.
- 4 The fourth stage—which the EU was ready to begin in the early 1990s—is an economic and monetary union. This phase was established by the Maastricht Treaty, or the Treaty on European Union, whose main purpose was to create a single currency and a central bank. It also changed the name of the European Economic Community to the European Union.



The perception that the European Union is some kind of socialist organization is not true. In fact, member states often argue among themselves that the EU is much too focused on the interests of corporations and not sufficiently concerned with the interests of workers.

## A Single European Currency

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- ◀ The desire for a single European currency began in August 1971, when the United States, under President Richard Nixon, abandoned the World War II-era Bretton Woods system of fixed exchange rates. Under floating rates, flows of goods, services, capital, and people among closely integrated EU member states could be highly disruptive.

- ◀ Under a floating-rate regime, the Sofitel hotel in Berlin would earn German marks and then have to convert its receipts to French francs either before or after the funds were sent back to corporate headquarters in Paris. If the exchange values of the German mark and French franc were constantly changing, this would create havoc with bookkeeping, taxes, and planning.
- ◀ The process to create the single currency and the European Central Bank was methodically laid out and minutely planned. The Maastricht Treaty is 253 pages long, and one of its most important and controversial components is the criteria imposed on each member state for entry and conduct. There are budget criteria, inflation criteria, and interest rate criteria.



The Maastricht Treaty gave birth to the EU flag: 12 gold stars on a blue background, each one representing the first 12 member states.

- ◆ Member states had to meet stringent budget requirements to participate in what became known as the Eurosystem. Public budget deficits—the national fiscal deficit—could not exceed three percent of gross domestic product. Total public debt—the aggregate of all stage borrowing—was not to exceed 60 percent of gross domestic product. Inflation was not to be higher than 1.5 percent of the average inflation rate of the three lowest-inflation member states.
- ◆ These very specific percentages were put in to placate the nervous Germans. The German government and monetary authorities were extremely reluctant to give up their valuable Deutschmark. They feared that a monetary system partially controlled by the Italians, Spaniards, and Greeks would be unstable and prone to inflation.
- ◆ Of the 12 countries who signed the Maastricht Treaty, only one—the United Kingdom—chose not to join the single currency. That now seems like a harbinger of the Brexit vote. All other member states gave up national control of domestic money supply, interest rates, and exchange rates.
- ◆ They also gave up some room to maneuver with regard to fiscal policy. In cases of severe recession, such as the financial markets crisis of 2007 to 2009, they were hamstrung in their ability to promote spending to counteract the slump in economic activity.
- ◆ This was particularly onerous for Greece and Spain, both of which suffered severe levels of unemployment, reaching upward of 25 percent of the labor force. Pensions, unemployment benefits, student stipends, and family benefits had to be cut. This was due to the mandate that budget deficits could not be increased above three percent of gross domestic product. Severe human suffering resulted from some quite arbitrary rules that had very little logical or economic basis.

- ▶ The Canadian American economist Robert Mundell predicted this disastrous result arising from his Nobel Prize-winning research on the subject of optimal currency areas. Mundell concluded that Europe, unlike the United States, was not an area well suited for a single currency.
- ▶ Mundell believes that America is better suited for a single currency for two basic reasons. First, labor and capital are pretty mobile in the United States; if unemployment increases in Michigan, it's not difficult for workers to move to Texas. Second, if one state in the United States is suffering from declining income and tax revenues, the pensions and unemployment benefits for its residents don't have to be cut.
- ▶ The economist Paul Krugman, in one of his *New York Times* columns, compared Florida to Greece. During the financial markets crisis, the U.S. government transferred billions of dollars to Florida residents in the form of Social Security benefits. The state of Florida does not have to fund the Social Security payments to its residents. Therefore, although the state of Florida does have to cut some spending due to the recession, the older residents of Florida do not have their federal pensions cut.
- ▶ The Greek government was the source of pension payments to its older citizens. Due to the effects of the Great Recession and the EU mandate to limit budget deficits, the Greek government had to cut the pension payments to its older citizens. There were no funds from the EU budget to provide money for Greek pensions.
- ▶ Europe's single currency does have enormous benefits, as well as some drawbacks. For multinational U.S. businesses who do business throughout the eurozone, it is much easier to manage exchange costs—and do accounting and planning—in one currency instead of several.

- ◀ Whether all of Europe will eventually adopt a single currency and complete the process of economic integration is a political choice as well as an economic one. The EU operates on democratic principles and cannot force its member states to adopt the euro or proceed along the path to further economic and political integration. The citizens of the member states have the power to decide the future of the EU.

### Readings

DE GRAUWE, *Economics of Monetary Union*.

REID, *The United States of Europe*.

### Questions

- 1 What are the real successes of the European Union, and why do these successes owe quite a lot to U.S. policy in the aftermath of World War II?
- 2 How do the particular requirements for joining the Eurosystem create real problems for member states who are suffering during recessions and depressions?



## *Lecture 24*

# Both Sides Now: Experiment in Slovenia

**C**OMPARATIVE ECONOMICS IS THE STUDY OF different systems of economic organization—notably capitalism, socialism, communism, and mixed economies. Today, debates about the nature of capitalism, socialism, and communism—and whether any or all of them can be reformed to function better in the interests of the general population—are common. What is the best path forward? In this lecture, a small central European country provides us with some clues about the future. ♦

## A Brief History of Slovenia

- ◀ Slovenia was a sliver of the Habsburg Empire for nearly 1,000 years, right up until World War I. After the war—torn between the forces of assimilation and independence—these south Slavic people (along with ethnic Croats and Serbs) hitched their star to what became the Kingdom of Yugoslavia, beginning in 1918. Later, during World War II, much of Yugoslavia was occupied by Nazi Germany and temporarily broke up as the Croats formed a Nazi-allied independent state.
- ◀ Under the communist partisan forces of Josip Broz Tito, Yugoslavia then reunited and broke away from Soviet influence in 1948. In 1961, Tito's Yugoslavia became a founder of the Non-Aligned Movement, which pursued a less orthodox path to communism than in the Soviet Union and east bloc.
- ◀ In June 1991, six months before the Soviets' ultimate collapse, Slovenia declared its independence from the disintegrating Yugoslav federation. A little more than a decade later, in May 2004, it completed its reorientation by joining the European Union (EU) and adopting the euro.



- ◀ Today, in many ways, Slovenia is attempting to be a modern, mixed economy with significant roles for private initiative, private property, and market incentives. But even as some Slovene citizens embrace participation in a European social market economy, others prefer to look backward to what they perceive as a more secure, and less stressful, socialist economy.

## Slovenia's Rapid Transition

- ◀ Slovenia made a rapid transition in recent decades from a socialist economy to a modern, middle-income market economy. It started on this path with many advantages, including both geography and history.
- ◀ As part of the former Austro-Hungarian Empire, Slovenia had always been linked to the important economies of central Europe. It borders Austria to the north and Italy to the west, and as the richest of the six constituent republics of the former Yugoslavia, and the one most involved in foreign trade, this strategic location helps us understand why.
- ◀ At one time, Slovenia accounted for less than 10 percent of Yugoslavia's population yet produced more than 20 percent of the country's gross domestic product and accounted for 40 percent of its exports.
- ◀ Another advantage the Slovenes enjoyed over many of their Slav neighbors is a language that employs the Latin alphabet, unlike Serbo-Croatian, which uses the Cyrillic alphabet. This gave it a linguistic advantage over the rest of Yugoslavia in adapting to the global language of English.

- ◀ The Yugoslav leader Josip Broz adopted the nickname “Tito” in the 1930s, when he rose to prominence as one of the leaders of the Communist Party of Yugoslavia. Because the party was illegal, it had to operate underground—and anonymously.

Throughout Europe in the 1930s, communist leaders often used nicknames to conceal their identities: Vladimir Illyich Ulyanov became Lenin, Lev Davidovich Bronshtein became Trotsky, and Ioseb Dzhughashvili became Stalin.

- ◀ During World War II, Tito led his army of Yugoslav partisans in the fight against Germany and Italy as well as against domestic fascists and royalists. The partisans were victorious, and Tito would end up leading Yugoslavia from 1945 until his death in 1980.
- ◀ He was able to break with the Soviet Union in part because he had his own army and had not been put in power by the Soviet Red Army. He also succeeded at creating his own version of communism, which was not as inefficient or stagnant as elsewhere in the eastern bloc.
- ◀ Still, Tito did adopt many components of the classic communist system. He led a one-party dictatorship that tolerated little dissent. And while communism promises equality, Tito was a bit more equal than all the rest of his fellow Yugoslavs, owning villas, a yacht, and an airplane.

- ◀ In contrast to Tito's strict dictatorial political control, he allowed some economic freedom, including a unique system of worker self-management. Each enterprise had some discretion about where to buy its inputs and where to sell its products. These decisions were made based on price and profit. This created—in workers and managers alike—some familiarity with market-oriented decision making that was almost completely absent elsewhere in eastern Europe (where virtually all important economic decisions were governed by central planners).
- ◀ Yugoslav enterprise managers had some knowledge of how markets determine prices and profits, and the Slovenes, in particular, had more of this knowledge than other Yugoslavs because they had constant exposure to the prices of the goods, services, and resources in their trade with Austria, Italy, and West Germany.
- ◀ That said, Yugoslavia's system of worker self-management was not without its idiosyncrasies. When workers have a say in how wages should be set and profit goals are determined, wages are pretty high—and profits are rather low.
- ◀ On the other hand, one of the real drawbacks of Soviet-style central planning was its emphasis on production, without equal consideration of input costs and markets. Soviet enterprises were evaluated on output. Whether the products actually sold, or were useful, was a secondary question.
- ◀ In the Soviet system, there was almost no incentive to limit resource use. In fact, the incentive was to accumulate—and use—as many resources as possible. More labor resources and stockpiled supplies, for example, meant greater ability to meet production targets.

- ◀ In the Yugoslav system, by comparison, enterprises could keep a large part of the profits they generated. This incentivized managers and workers to economize on their resources. Resource conservation, in terms of power and raw materials, meant lower costs and higher earnings, whereas hiring more workers meant a smaller slice of the profit share.
- ◀ Another lasting value of worker self-management is the shared sense of equality and solidarity. Modern production processes tend to turn on team efforts. You need many skills and individuals to produce most goods and services. Workers know this. Everybody working with the team is valuable. They are also human beings, with individual dignity.
- ◀ Tito emphasized his independence by leading the Non-Aligned Movement of countries, along with Egypt under Gamal Abdel Nasser and Indonesia under Sukarno. By playing both sides in the Cold War against each other, the Non-Aligned countries gained benefits from both sides.

## Slovenia's Economy

- ◀ The Slovenian economy's many differences uniquely poised it to take advantage of the eventual fall of the Yugoslav federation.
- ◀ At the time of independence, Slovenia had three times the per capita gross domestic product of fellow ex-communist states Poland, Hungary, and Czechoslovakia and was at a level of income and development not far behind Portugal. But do all the factors contributing to Slovenia's economic and social success have to do with adopting a free market, capitalist system? Or

have the Slovenes continued some of their own unique values? The answers to these questions—to the extent we have them—are complicated.

- ◆ Slovenia adopted a market economy with private property and monetary incentives, and it also became even more oriented to international trade. But it also retained some of the solidarity and cohesion of a more socially oriented system.
- ◆ To be admitted to the EU, a country must meet three basic criteria, known as the Copenhagen criteria, adopted by the EU before the accession of some of the former communist countries of eastern Europe in 2004. The three Copenhagen criteria were parliamentary democracy, human rights, and a market-based economy.
  - 1 Parliamentary democracy means freedom for political parties and voting based on nondiscriminatory eligibility of citizens. Russia would fail to meet these criteria today.
  - 2 Human rights mean equality for women and religious, ethnic, and national minorities. It also means the abolition of capital punishment. The United States fails to meet these criteria.
  - 3 A market-based economy means support for private enterprise and private property. It does not mean the abolition of all state property or the elimination of government regulation. It means that the majority of production and consumption decisions are made on the basis of enterprise profit and consumer choice. Slovenia met these criteria.

- ◀ But even after joining the EU, Slovenia and the other former east bloc states had to meet a second set of requirements to adopt the euro in 2007. This was an additional step for Slovenia in its progress to becoming a full member of the European economic integration process.
- ◀ These additional criteria were established by the 1992 Maastricht Treaty to integrate the European economies. They include guidelines on domestic inflation, interest rates, fiscal deficits, and public debt levels. Slovenia was the first of its eastern peers to meet all these criteria.
- ◀ In the years since, Slovenia has been a fast globalizer and international trader. Consistent with its history in trade, Slovenia exports a sizeable portion of its gross domestic product—about three-quarters of gross domestic product, according to the Organization for Economic Cooperation and Development (OECD). The OECD average is 28.9 percent. At the same time, as an export engine, Slovenia is heavily dependent on the rest of the world's economies. And that means it gets hit hard when there is a global recession.
- ◀ Slovenia has also maintained a strong social safety net—and a high level of economic security—while achieving impressive growth and exports. The Slovenian constitution states that it is a social state, which means that the government takes significant responsibility for the health, welfare, and economic security of the population.



Most of the  
U.S. economy  
is domestic  
while most of  
the Slovenian  
economy is  
globalized.

- ◀ The results of Slovenia's social welfare approach to caring for its population have been impressive. Not only has the life expectancy of Slovenians increased substantially, but measures of social solidarity have also been impressive. For example, the poverty rate is relatively low in Slovenia, even compared to the United States.
- ◀ Across the world, incomes have been becoming more and more unequal in recent decades. An economist's most commonly used measure of inequality is the Gini coefficient, which can range in value from 0 (meaning complete equality) to 100 (meaning that one person has all the money).
- ◀ For the OECD countries as a whole, the Gini coefficient is 32, and for the European Union more narrowly, it is 29. In the United States, by comparison, the Gini coefficient is 39 and has been increasing since the early 1980s. In Slovenia, the Gini coefficient is 25—the lowest of all OECD countries.
- ◀ But you get what you pay for. And the Slovenes pay a lot. As a percentage of total income, the Slovenes pay 44.9 percent of their incomes in taxes. The OECD average is about 40 percent. And of all the OECD countries, the Norwegians pay the most, at 54.8 percent. The United States is one of the lowest-tax countries in the OECD, with the third-lowest rate after Ireland and Mexico.
- ◀ This reflects an important trade-off between social solidarity and individual economic freedom and independence. In the United States, you can make a lot of money and keep most of it. But all of the trade-offs inherent in competing economic systems are controversial, and there's no definitive answer about what kind of economic system is best. We make choices—from public education, to health care, to taxes, and the social safety net. Different histories, cultures, and values always lead to different choices for a country's economic system.



## Are the World's Economies Converging?

Are the world's economies becoming more similar? In other words, is there convergence toward a single economic and political system? Or are the world's economies diverging?

The American political scientist Francis Fukuyama laid out an argument for the idea of convergence in his controversial 1992 book, *The End of History and the Last Man*, in which he predicted that all economies would become private enterprise, deregulated systems with little state ownership or control. But it hasn't turned out that way.

And it's not likely that economic systems will be converging anytime soon. Many different economic systems operate side by side in the world today, and there will probably be many different economic systems far into the distant future.

## Readings

DRAKULIC, *Café Europa*.

FUKUYAMA, *The End of History and the Last Man*.

## Questions

- 1 What makes Slovenia such a good example of the benefits of European economic integration and the institutions of a mixed economy? How did Slovenia's unique history prepare it to take advantage of the opportunities it was given by national independence in 1991?
- 2 Does the Slovenian example provide evidence for all economic systems converging to a single system of free market capitalism as exemplified by the U.S. economy? Is there another economic system that you think would be an ideal system for all the world's economies?

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